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GENERAL DISCUSSION ON TRANSNATIONAL CORPORATIONS IN THE WORLD ECONOMY AND TRENDS IN FOREIGN DIRECT INVESTMENT IN DEVELOPING COUNTRIES

The emergence of integrated international production

Report of the Secretary-General

SUMMARY

Transnational corporations have been adopting strategies that involve closer integration among their different activities and among their foreign and domestic locations. The new strategies, which coexist with older ones, have led transnational corporations to establish regional networks of affiliates and non-affiliated companies, and in some instances to seek linkages across regions. The new strategies are related to major global changes, including the formulation of regional trading groups.

The complex international production strategies of many transnational corporations are a central feature in an emerging, integrated international production system. This new system, advanced in some areas and embryonic in others, is being shaped by the activities of transnational corporations and by major changes in technology and public policy. How most developing countries fit into the emerging system remains an open question.

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* E/C.10/1993/1.

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INTRODUCTION

1. At its eighteenth session, the Commission on Transnational Corporations requested the Secretary-General to prepare reports on transnational corporations in the world economy and trends in foreign direct investment in developing countries. 1/ The present report has been prepared in response to that request. The Commission also has before it related reports of the Secretary-General on trends in foreign direct investment (E/C.10/1993/2), the growth of foreign direct investment in the 1980s: trend or bulge? (E/C.10/1993/3) and the universe of transnational corporations (E/C.10/1993/11).

2. The rapid growth of foreign direct investment in the 1980s has been widely seen as evidence of the growing importance of transnational corporations in the world economy. 2/ World-wide flows of foreign direct investment grew three times faster than world exports and almost four times faster than the value of world output between 1983 and 1990, giving evidence of the growing importance of foreign direct investment in global economic integration. 3/ For most host economies for which data exist on a variety of measures of the relative importance of foreign direct investment and the activities of transnational corporations, it seems clear that the economic role of transnational corporations grew larger over the decade of the 1980s. 4/

3. The growth of foreign direct investment is only one measure of the importance of transnational corporations to world-wide economic development and their impact on host economies. Transnational corporations also control international production through non-equity linkages, such as franchising, subcontracting and joint ventures, and have increasingly engaged in strategic alliances with potential competitors, especially in high technology activities. The impact of transnational corporations on host economies includes not just the provision of capital through inflows of foreign direct investment but also the transfer of technology, including management expertise; the expansion of the host country role in international trade; the transfer of skills to host country nationals; and a stimulus to host country business enterprise through the local purchasing of raw inputs, business services and manufactured components. Transnational corporations contribute a package of attributes to the economies in which they operate. 5/

4. Transnational corporations adopt strategies to achieve both short-term and long-term objectives (such as a target rate of profit on invested capital and a rising market share or growth in the market value of assets) by utilizing the assets and abilities they own and control in the context of the economic and policy environment in which they operate. 6/ Strategies are formulated by a firm's decision makers as they evaluate and project the competitive strengths possessed by the firm, the likely strategies adopted by competitors and economic and policy conditions. The choice of strategy can differ across firms to the extent firms have different strengths and objectives, operate under different conditions or are subject to different judgements on the part of top managers.

5. Transnational corporations adopt or modify organizational structures in order to carry out their basic strategies. 7/ For example, in the United States of America, the multi-plant and multi-divisional organizational structures adopted by many manufacturing corporations in the first half of the

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twentieth century were a response to the need to manage production for a large, diverse and geographically dispersed national market. These structures also led to the wider application of professional managerial skills and to the realization of cost savings from internalizing activities within the corporate organization. 8/ The successful application of this organizational structure gave United States corporations a competitive advantage in managing cross-border production. 9/

6. The content and distribution of the activities of transnational corporations is largely a function of aggregate economic conditions, the strategies adopted by transnational corporations and the organizational forms utilized to carry out those strategies. This report analyses recent developments in the strategies and organizational structures of transnational corporations, which are affecting both the functional and geographical organization of the activities of transnational corporations. Section I analyses the factors behind the evolution of strategies towards those involving a greater degree of cross-border integration of the functions that comprise a transnational corporation's value chain (see box 1). Section II analyses the changing geographical scope of corporate strategies, in particular the growth of regionally oriented networks organized by transnational corporations. Section III analyses the evolution of the strategies of transnational corporations towards a more complex form of organizing international production, while section IV discusses the implications of these trends for developing countries.

Box 1. The value chain of a firm

The concept of a chain of value added, or value chain, is a tool for analysing how a firm organizes and performs the discrete activities that add value to the goods and services it produces and sells to its buyers. A number of these activities are linked together vertically, in that each depends upon activities that occur at a prior level and feed into activities that occur at a later level. Other activities occur at any and all points and can be seen as linked horizontally.

Drawing upon the framework developed by Porter, a/ vertically linked activities include inbound logistics, such as site selection; operations, such as component assembly and final assembly in manufacturing; outbound logistics, such as movement of products; marketing, such as advertising and sales; and after-sales service. Horizontally linked activities include human resource management; research and development; procurement; finance; accounting; and other management functions, sometimes labelled as firm-wide infrastructural functions. While all firms perform all of these activities, their importance varies across companies and across products. Thus, operations and after-sales service are more important in automobiles and consumer electronics than in detergents, while services firms define operations quite differently from manufacturing firms. In addition, the importance of horizontal and vertical linkages may differ across companies. The ability of a firm to identify and exploit which of these activities and linkages are the most important for its overall performance is frequently seen as a source of success. b/

The activities within a value chain can be linked in a variety of ways and can be more or less closely integrated, combining intra-firm, extra-firm and cross-border linkages. The form and closeness of the linkages are determined by a corporation's strategy, its organizational structure, the external environment (especially costs), the demand for its output and public policies.

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a/ Michael E. Porter, The Competitive Advantage of Nations (New York, The Free Press, 1990), pp. 40-44; see also John H. Dunning, Multinational Enterprises and the Global Economy (Wokingham, England, Addison-Wesley, 1993), especially chap. 7.

b/ Porter, op. cit., chap. 2; C. K. Prahalad and Gary Hamel, "The core competence of the corporation", in Gunnar Hedlund, ed., Organization of Transnational Corporations, United Nations Library on Transnational Corporations (London, Routledge, 1993).

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I. FUNCTIONAL SCOPE OF INTERNATIONAL PRODUCTION

A. Functions of the firm

7. Firms exist in order to organize the production and distribution of goods and services. In the absence of firms, production and distribution would be organized largely through arm's-length market transactions between the owners of productive equipment, labourers, owners of distribution facilities and consumers. Many of these transactions are internalized within the firm and thereby take place outside of markets. The extent to which a firm internalizes arm's-length transactions depends on its ability to achieve scale economies in production and distribution and its ability to achieve coordination economies emanating from the extension of common governance over a larger share of economic activity. In many industries, the widening scope of internalized activity suggests the presence of substantial efficiency gains. 10/

8. The business firm performs a number of functions as part of the process of organizing the production and distribution of goods and services. The firm purchases or hires, and, in the case of labour, trains productive inputs; it combines these inputs to create goods and services; and it distributes and markets these goods and services to its customers. Corporations have specialists to handle these functions under such headings as procurement, human resource management, advertising and distribution. In addition, large and complex corporations require a range of managerial functions, including capital budgeting, cash management, accounting, information systems, strategic planning and legal and government relations.

9. Most firms originally serve national or subnational markets (exceptions would include firms established to engage in international trade or the international exploitation of natural resources). Firms build upon the competitive advantages gained in domestic markets to serve international markets, either via exports or by locating and controlling value-adding activities within host economies, a process called international production. International production includes all activities organized and controlled by transnational corporations within host economies that contribute to the value of output, including the creation of both goods and services and intermediate and final products. The choice between serving foreign markets through exporting or serving them through international production depends on how a firm evaluates the best manner of utilizing its competitive advantages, the gains to be made from the particular location in question and the potential gains from internalizing cross-border activities within the organizational structure of the firm. 11/ In many instances, the choice between exporting and international production will be strongly influenced by host country policies, including the degree and nature of trade barriers.

10. Firms that engage in international production need to adopt strategies and organizational structures that are suited to this form of international economic activity. Strategies for organizing the cross-border production of goods and services involve choices about the international location of different activities within a firm's value chain and the degree of integration among the various entities that fall under the common governance of the firm. Individual firms build upon their own advantages, which are heavily influenced by home country conditions but which are increasingly affected by the international

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environment as firms expand their international production. Those firms that can most effectively adapt their strategies and structures to include elements derived from international production are the most successful in attaining or maintaining a global competitive advantage.

11. The range of possible strategies and organizational structures utilized by transnational corporations has evolved and expanded over time, as these firms have responded to major changes in the international economic, technological and policy environment (see table 1). Individual transnational corporations have adopted these strategies and structures to different degrees, because many of the conditions they face and the responses they select vary considerably. There is, however, an increasing tendency for transnational corporations to adopt strategies and structures that involve a greater degree of integration of functional activities between parent firms and their foreign affiliates, and among affiliates. The evolution of strategies towards those involving an increasingly complex set of relationships is evidence of the increasing functional integration of the activities of transnational corporations.

Table 1. Evolution of transnational corporation strategies and structures

Form	Types of intra-firm linkages	Degree of integration	Environment
Stand-alone (e.g., multi-domestic)	Ownership, technology	Distant	Host country accessible to foreign direct investment; significant trade barriers; costly communications and transportation
Simple integration (e.g., outsourcing)	Ownership, technology, markets, finance, inputs	Close at some points of value chain, distant at others	Open trade regime, at least bilaterally; non-equity arrangements; open foreign-direct investment regime
Complex integration production (e.g., regional core networks)	All functions	Potentially close throughout value chain	Multilateral trade and foreign-direct-investment regime; information technology; convergence in tastes; heightened competition

B. Stand-alone strategies

12. One common form of strategy utilized by transnational corporations is the establishment of stand-alone affiliates. In this strategy, parent transnational corporations control affiliates in one or more host countries, with each affiliate operating largely as an independent concern within the host economy. The primary link between the parent and affiliate is control through ownership,

although additional links can exist in the form of technology transfer or the supply of long-term capital. In general, however, a stand-alone affiliate is responsible for its output for most of the elements of the value-added chain. It may meet this responsibility purely internally, or through relationships with firms within or outside the host economy. Transnational corporations can control a large number of stand-alone affiliates, each serving a host economy and other markets and each having a direct organizational link to the parent.

13. Stand-alone affiliates are utilized in a variety of industries. Manufacturing affiliates serving host country markets, especially in cases where the host economy can provide significant resource inputs and where imports of materials and components are difficult or expensive, can be organized in a stand-alone mode. Such affiliates often develop their own linkages within the host economy with suppliers and subcontractors, thereby replicating within the host economy the organizational model employed by the parent firm. In many services industries, such as hotels and advertising, firms frequently operate as self-contained entities, offering their customers a complete package of services.

C. Simple integration

14. For some transnational corporations, their primary foray into international production occurs via outsourcing, with some activities within a firm's value chain being performed in host countries and linked to activities performed elsewhere. In manufacturing transnational corporations that utilize outsourcing, significant components or subsystems are manufactured in host countries and in some instances final assembly occurs in host countries, while the final product is sold in the home country or exported to world markets. The clothing industry provides many examples of outsourced international production; large, retail chains, such as Montgomery Ward (United States of America) and Marks and Spencer (United Kingdom of Great Britain and Northern Ireland), which have increasingly dominated the market in the developed economies, rely heavily on subcontracted production from developing countries. In addition, many natural resource affiliates represent examples of outsourcing, since they provide an initial step along the parent firm's chain of value added. Transnational services corporations have also utilized outsourcing, as in the use of foreign affiliates or subcontractors to process data or write software. 12/

15. Outsourced international production represents a transfer of some value-adding activities to locations other than the home country and the primary country or countries of final sale. The primary motive for outsourcing is to utilize the locational advantages of a host country with respect to a portion of a transnational corporation's value chain. Outsourced production is controlled by the parent transnational corporation either through ownership of the affiliate or through non-equity arrangements with local producers, such as subcontracting or joint ventures. The extent and nature of the intra-firm linkages may depend on where and how the outsourced production fits into a parent firm's value chain. Affiliates or firms related to the parent firm through non-equity arrangements cannot stand alone but must be integrated into the parent firm's value chain through the establishment of functional linkages.

Thus, integration of some corporate functions is required to manage outsourced international production.

16. More generally, outsourcing is predicated on the reduction or elimination of trade barriers between the home and host countries, on transnational corporations having access to host countries for foreign direct investment and on the existence of a low level of transport costs relative to the value of the outsourced output. The general lowering of tariff barriers under the General Agreement on Tariffs and Trade (GATT) regime and specific actions on the part of some developing countries to lower trade barriers as a component of development strategies has widened the geographic scope for the location of international production. Export-processing zones are often the location of outsourced production, with the maquiladoras along the border between Mexico and the United States providing an example.

D. Complex integration

17. More recently, a form of complex integration is emerging, whereby international production can occur at almost any point on a firm's value chain. Complex integration strategies are based on a firm's ability to undertake economic activities in any locations that are best suited to contributing to the profitability of the entire value chain. Under complex integration, any affiliate operating in any location can potentially perform functions for the firm as a whole. Output produced within host countries is combined with output from other host countries or the home country to create final products that are assembled in either host or home countries for sale in the home country, in host countries, or exported to world markets. Each distinct operation is evaluated in terms of its contribution to the entire value chain. There is a high degree of functional integration among the different processes occurring in various locations. Complex integration requires a willingness to locate various functional activities to meet the needs of the overall strategy, including not just production but also research and development, finance, marketing and other functions. Complex integration represents a further internalization of market transactions through either foreign direct investment or non-equity arrangements, thereby expanding the scope for obtaining economies of common governance. Industries such as automobiles and consumer electronics provide examples of complex integration. 13/

18. Complex integration strategies are being adopted by transnational corporations in response to major developments in the global economic environment. These include advances in information technology, a tendency towards greater cross-national convergence in demand patterns and an intensification of competition world wide. In addition, national and regional policy changes are also having an effect on the strategies of transnational corporations (see sect. II).

1. Technological developments

19. Rapid advances in technology have fostered the emergence of complex integration strategies for transnational corporations. Continuing advances in informatics and telecommunications have increased the capabilities and reduced

the costs of processing and communicating information; some portable computers can now perform more tasks at lower cost than many of the large mainframe computers of a generation ago. These improvements have allowed a decentralization in the utilization of information technologies and their widespread application throughout the value chain, which in turn has paved the way for the spread of flexible production technologies and new management and research-and-development practices throughout the world economy. Using new technologies, information can be transmitted in larger quantities to more locations and at lower cost than previously. Thus, information technologies have helped create possibilities for locating different components of a firm's value chain in host country locations, giving the parent transnational corporation greater scope for applying complex strategies.

20. Information technologies are also critical in coordinating activities across the value chain, another important element in complex integration strategies. The expansion of complex international production implies a growing role for the cross-national coordination of production and resource flows within a corporation. Similar to the manner in which the establishment of multi-plant and multi-divisional structures created the need for a larger managerial function within the corporation, the development of complex integration strategies has increased the opportunities for transnational corporations to gain competitive advantages from the management of their cross-border networks. The application of information technologies permits greater savings in managing inventories throughout a production system and a more rapid response to changes in consumer demand. Such flexibility has allowed the introduction of complex strategies in industries that were previously the purview of national firms or transnational corporations operating under stand-alone strategies. Examples include Bennetton (Italy) and Levi Strauss (United States) in the clothing industry and IKEA (Sweden) in the furniture industry; these are all transnational corporations that have used information technologies to match production more closely with demand patterns in all of the host countries in which they operate.

2. Role of demand patterns

21. For some transnational corporations, the move to complex integration is stimulated by their attempts to serve world-wide product markets. Rising consumer demand and the tendency towards a cross-national convergence of certain consumer tastes have contributed to this trend. 14/ The growth of demand has opened and expanded markets in all regions of the world; at the same time, there has been a tendency for national and regional differences in product demand to become less important and for an increasing number of products of identical or similar design to be sold in multiple markets simultaneously. There are numerous examples of products, such as clothing, food, electronic goods, cameras and recorded music, that are marketed globally. Other products, including some automobile models, are often sold in different markets with relatively minor alterations.

22. The tendency for demand patterns to exhibit some convergence is due partly to a convergence in productivity and economic growth rates since the Second World War (at least among the developed economies); partly to the spread of communication technologies which increase the cross-national visibility of

national consumption patterns; and partly to marketing efforts by transnational corporations, especially the transnational spread of advertising. As products become more standard across countries, the ability of firms to be present in multiple markets increases. At the same time, it becomes necessary for firms to be present in multiple markets in order to challenge competitors and strengthen competitive positions throughout the world. 15/

23. The cross-national convergence of consumer tastes is, however, incomplete. Many products remain differentiated, due to important differences in culture, economic conditions and government regulations across countries. 16/ For example, the rationalization of the white goods industry within Western Europe has been limited by cross-national differences in demand patterns with respect to the size and design of household appliances. But the growing utilization of flexible production technologies has made it possible for firms to tailor output to niche markets without suffering large penalties in terms of higher costs, as was the case under mass production. However, such differences in demand and production suggest that national and regional factors will remain important in determining future strategies of transnational corporations.

3. Intensified competition

24. An important development fostering complex integration has been an intensification of international competition. The rapid growth of foreign direct investment has been accompanied by a substantial increase in the number of transnational corporations and the number of their foreign affiliates. For 1968-1969, it was estimated that there were more than 7,000 transnational corporations headquartered in the developed economies with more than 27,000 foreign affiliates. 17/ By the early 1990s, some 35,000 transnational corporations had been identified, and some 170,000 foreign affiliates. 18/ Moreover, the distribution of transnational corporations by home countries has become broader, to include more developed economies and a growing number of developing economies, giving further indication of intensified competition. In 1968-1969, almost 60 per cent of the transnational corporations from the developed economies came from two home countries, the United Kingdom and the United States; at the beginning of the 1990s, four home countries - Germany, Japan, Switzerland and the United States - accounted for 49 per cent of the transnational corporations based in the developed economies and the United Kingdom had slipped to seventh place. In addition, data on bilateral stocks and flows of foreign direct investment show that transnational corporations from the developed economies concentrate their foreign direct investment activities in other developed economies, indicating a substantial interpenetration of these economies by transnational corporations as well as large amounts of intra-industry cross-investments. 19/

25. The intensification of competition, combined with rapid advances in production technology, have provided a stimulus for transnational corporations to seek out new mechanisms for gaining international competitive advantages. Thus, firms have increased their efforts to attain cost savings and profit sources from foreign locations and from different elements of their value chains.

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26. These various factors have led to the adoption of strategies by transnational corporations that are increasingly of a network character. Networks involve a movement away from the hierarchical linkages typically found in stand-alone and simple integration strategies towards more complex combinations of horizontal and vertical linkages, with decision-making decentralized for some corporate-wide functions. Within networks, resources flow in both directions between parent firms and their foreign affiliates, and between individual affiliates. Networks develop complex cross-national linkages (see sect. II below) and closer integration both within firms and across firms (see sect. III below).

II. GEOGRAPHICAL SCOPE OF INTERNATIONAL PRODUCTION

A. Multi-country strategies

27. Stand-alone affiliates are often utilized as a component of a company-wide multi-domestic or multi-local strategy, whereby an affiliate primarily serves a single host country market while the parent corporation controls a number of affiliates in different markets. The existence of trade barriers with respect to both final and intermediate products, including high local-content requirements, have frequently required transnational corporations to adopt multi-domestic strategies in order to enter specific host economies. In some industries, for example retailing and food production, the absence of major technological improvements in such areas as communications, transportation and production management, the difficulty in achieving scale economies and the importance of cross-national demand differences also lead to multi-domestic strategies. In such instances, transnational corporations coexist with national firms in host country markets; the ownership and coordination advantages of transnational corporations compete with the knowledge of local conditions possessed by the national companies. Many transnational services corporations adopt multi-domestic strategies, since their output typically can only be delivered to host country markets via international production. In addition, small and medium-sized enterprises often concentrate their efforts on serving markets in close proximity to their home economies.

28. In recent years, technological advances in transportation and communications have reduced costs of cross-national coordination. As trade barriers have been reduced and as regional economic groupings have been formed, there have been a number of instances where transnational corporations have begun using a single affiliate to serve more than a single host country. This has occurred within the European Community as part of the transition to the Single Market and is occurring in the four-nation Common Market of the Southern Cone (Argentina, Brazil, Paraguay and Uruguay) in South America. 20/

B. Regional strategies

29. Many transnational corporations have developed production networks, comprising parent firms, affiliates and non-affiliated companies, that are primarily organized along regional lines. Regionalized international production includes affiliates located in a number of host countries within a single region, along with non-affiliated companies acting as suppliers and

subcontractors. Final assembly occurs in different countries within the region and a major market for the product is the same region. Regional core networks of transnational corporations have been noted in Europe and include affiliates located in Central and Eastern Europe as well as in Western Europe, in North America (especially with the growth of foreign direct investment into Mexico in recent years) and in East Asia, as a number of the newly industrializing economies have become important production locations and final markets. 21/

30. Evidence on foreign-direct-investment stocks and flows to developing countries from the three Triad regions (the European Community, Japan and the United States) suggests a clustering along regional lines, with United States transnational corporations being the dominant investors in much of Latin America and the Caribbean, Japanese transnational corporations being increasingly dominant in developing Asia and transnational corporations from the European Community occupying dominant positions in Central and Eastern Europe and much of Africa (see figure I). Such clustering of foreign direct investment is consistent with a strong regional orientation of the strategies of transnational corporations. 22/ In addition, evidence on strategic technology alliances indicates that the most common form of alliance is between firms located within a single Triad region, while the second most common form involves transnational corporations from a Triad region having alliances primarily in one other Triad region. Transnational corporations with alliances in a number of regions constitute a small proportion of the total. 23/

31. Changes in policies have been a major stimulant to regional strategies on the part of transnational corporations. In particular, the lowering of tariff barriers has permitted a wider geographical scope for the location of functionally integrated international production, while the liberalization of restrictions on foreign involvement in host economies, the deregulation of many industries (especially in the services sector) and the privatization of previously State-owned companies are partly behind the rapid growth of foreign direct investment in the 1980s. The growth of intergovernmental agreements to form or strengthen regional economic groupings, including the Single Market within the European Community, the European Economic Area and the North American Free Trade Agreement, has increased the incentives for transnational corporations to formulate regional strategies. However, the growth of such strategies in East Asia has largely occurred in the absence of intergovernmental agreements; instead, they have been fostered by the lowering of trade barriers on the part of countries of the region, the increasing competitive strengths of many of these countries and the desire of Japanese transnational corporations to develop lower-cost production locations following the rise in the international value of the yen after 1985. 24/

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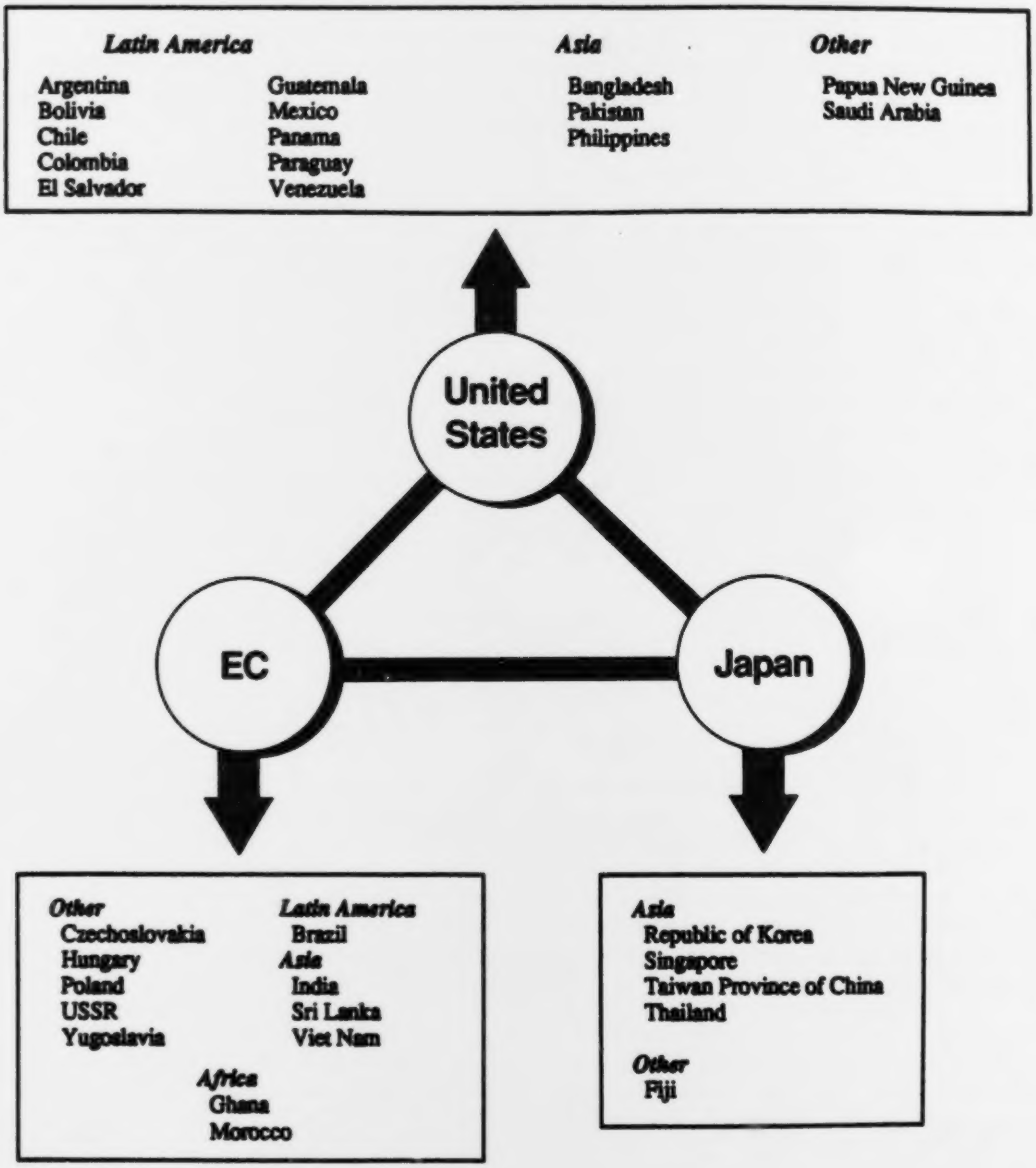
Figure I. Foreign-direct-investment clusters of Triad members, 1986-1989


Latin America
Argentina
Bolivia
Chile
Colombia
El Salvador
Guatemala
Mexico
Panama
Paraguay
Venezuela
Asia
Bangladesh
Pakistan
Philippines
Other
Papua New Guinea
Saudi Arabia
United States
EC
Japan
Other
Czechoslovakia
Hungary
Poland
USSR
Yugoslavia
Latin America
Brazil
Asia
India
Sri Lanka
Viet Nam
Africa
Ghana
Morocco
Asia
Republic of Korea
Singapore
Taiwan Province of China
Thailand
Other
Fiji

Source: World Investment Report: Transnational Corporations as Engines of Growth (United Nations publication, Sales No. E.92.II.A.19), p. 33.

C. Global strategies

32. Transnational corporations have often been described as having global strategies. The term is frequently utilized to delineate cross-border functional linkages and degrees of integration and does not necessarily have a geographical scope. 25/ The term also describes the approach of many transnational corporations that seek to be present in all of the world's largest markets in order to take advantage of the growth and convergence of demand, as well as to compete effectively with other corporations. However, the world-wide spread of product categories, brand names and other indices of transnational corporations' sales activities is not necessarily accompanied by a similar geographical spread of all the locations of all the activities that comprise the value chain. Indeed, the initial strategy of some transnational corporations in meeting global demand is often to produce most of their output within their home country and distribute it globally either via exporting or through affiliates established in host countries largely as trading entities.

33. Transnational corporations are frequently able to serve global markets with networks that are largely concentrated on a regional or subregional basis. One prominent example is the strategies adopted by the largest Japanese transnational corporations in the automobile industry. Honda, Nissan and Toyota have all established or are in the process of establishing regional networks for the production and distribution of automobiles in each of the major Triad regions. 21/ Each network is linked to the parent corporation through ownership and other important linkages, is linked to affiliates and non-affiliated firms outside its region and sells some of its output outside its region. Moreover, individual products are quite similar across regions. However, an increasing proportion of the functions that comprise the value chain and the share of value added remains within the primary region of operations. Thus, these transnational corporations are meeting global objectives through the increasingly regional organization of their value chains.

34. Over time, transnational corporations may seek to adopt a greater geographical dispersion of the bulk of their activities (see box 2). At present, in those manufacturing industries that have proceeded the furthest in establishing complex international production, the economic benefits of widening the geographical scope beyond the regional level for many activities have not justified such moves. Some functions, such as finance, may operate globally; others, including worker training, remain largely national. The focus, however, appears increasingly to be on a regional orientation for much of the value chain. At the same time, the establishment of regional trade arrangements, in some cases with significant barriers to extraregional trade, such as local content restrictions that effectively limit extraregional trade in components, may also be an element restricting the growth of global strategies in the organization of the value chain. 26/

Box 2. Ford's Western European operations: an example of strategic evolution

The European operations of the Ford Motor Company (United States) present an example of the evolution of a transnational corporation's strategy over time. Ford was one of the first manufacturing corporations to attain significant competitive advantages through exploiting economies of scale in mass production. Because of high transport costs and trade barriers, Ford entered the Western Europe market not through exporting from the United States but via greenfield foreign direct investment, in 1911 (United Kingdom) and 1913 (France) and expanded further in the 1920s. Ford's affiliates in Western Europe increasingly operated in a stand-alone, multi-domestic mode, as trade barriers expanded and nationalist pressures remained high in an era dominated by two major wars and the Great Depression.

With the establishment of the European Community, Ford began to reorganize its production relations within Western Europe. A multi-domestic orientation was replaced by a regional one. Declining trade barriers, especially within the European Community, allowed for extensive cross-border movements in components and final products. For its highest selling models, Ford established multiple assembly and component plants, to take advantage of plant-level scale efficiencies and reduced transport and communications costs, while also remaining capable of meeting demand shifts and offsetting work stoppages throughout Western Europe (see figure II). Ford's models were specific to Western Europe and while European operations drew on the parent firm's resources, Ford of Europe operated with a substantial amount of autonomy, developing its own research and development, marketing and financial management.

Recently, Ford announced plans to revive the notion of a "world car", a single model, assembled and sold in multiple markets and sourced globally (Ford also announced it is considering establishing a North American production network for the next model of the Jaguar, to exist alongside the United Kingdom network). Ford's Mondeo, to be introduced in Europe in 1993 and North America in 1994, will be assembled at plants in both regions, with major components, including engines and transmissions, built in both markets, and other components emanating from common suppliers either owned by Ford or linked through non-equity arrangements. The Mondeo, under development since the mid-1980s, is a response to the high fixed costs and excess capacity plaguing the automobile industry. It is designed to take advantage of flexible production technologies; improvements in transportation and communications; convergence of consumer tastes and safety and emissions regulations; and regional trading arrangements (the United States assembly plant will be supplied from an engine factory in Mexico).

Ford's previous attempt to construct a world car, the Escort, did not succeed, in part because Ford did not establish a single organizational

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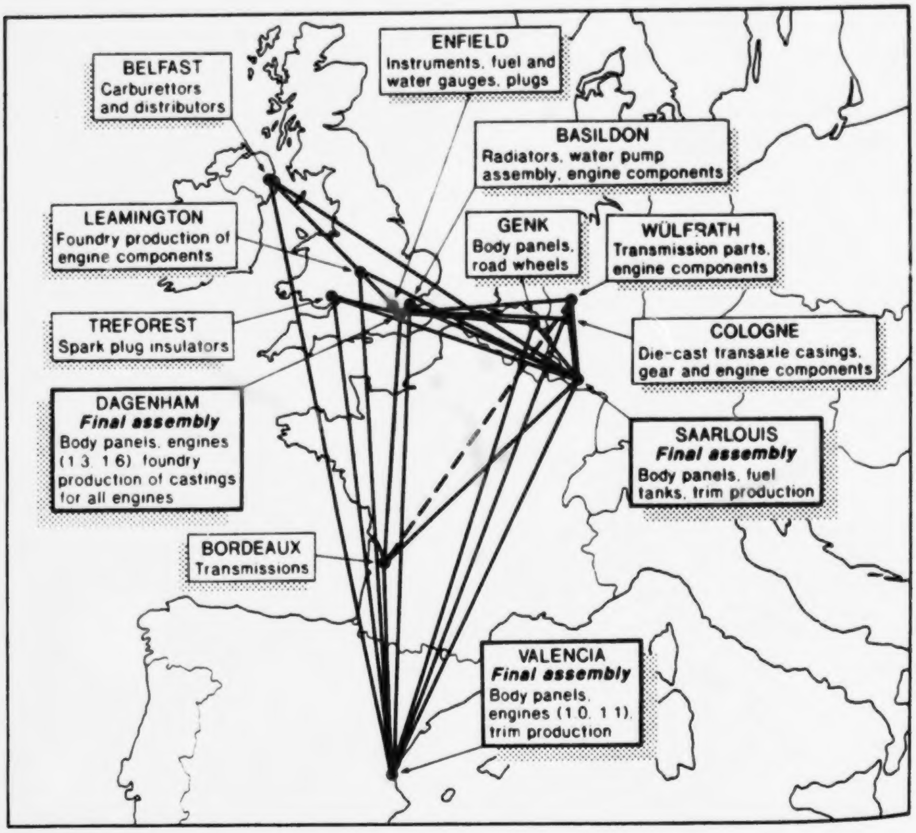
structure for product development. Although the Escort name was utilized in both Western Europe and North America, the two cars were distinct products. Ford has developed a new communications network for the Mondeo in order to integrate the work of research-and-development personnel world wide. If the Mondeo succeeds, it will represent an important step towards the extraregional integration of functional relationships. However, since Ford serves the Asia and Pacific market largely through exporting, this extraregional integration would encompass only two of the Triad's three legs.

Source: Peter Dicken, Global Shift: The Internationalization of Economic Activity (New York, The Guilford Press, 1992), pp. 298-302; Kevin Done, "A model to smash the mould", Financial Times, 6 January 1993; Richard A. Melcher, "Meet Ford's brave new 'world car'", Business Week, 18 January 1993.

Figure II. The Ford Fiesta production network in Western Europe


BELFAST
Carburettors and distributors
ENFIELD
Instruments, fuel and water gauges, plugs
BASILDON
Radiators, water pump assembly, engine components
LEAMINGTON
Foundry production of engine components
GENK
Body panels, road wheels
WÜLFRATH
Transmission parts, engine components
TREFOREST
Spark plug insulators
COLOGNE
Die-cast transaxle casings, gear and engine components
DAGENHAM
Final assembly
Body panels, engines (1.3, 1.6) foundry production of castings for all engines
SAARLOUIS
Final assembly
Body panels, fuel tanks, trim production
BORDEAUX
Transmissions
VALENCIA
Final assembly
Body panels, engines (1.0, 1.1), trim production

Source: Peter Dicken, Global Shift: The Internationalization of Economic Activity (New York, The Guilford Press, 1992), p. 300.

III. INTEGRATED INTERNATIONAL PRODUCTION

35. Changes in the global economic and policy environment have led transnational corporations to begin to adopt strategies that involve a growing degree of integration both across the functions performed by the firm and across a wider geographical area. This combination of greater functional and geographical integration is leading to an evolution in how transnational corporations organize the international production of goods and services, both within the traditional purview of the firm and across firms in wider organizational networks.

A. New organizational responses

36. Complex integration strategies pursued in a wider geographical context frequently require complex organizational structures. With international production occurring throughout a firm's value chain, a hierarchical structure may not provide sufficient flexibility to deal with conditions that may change rapidly at one point but not be changing at others. Similarly, basic corporate-wide functions, such as research and development, strategic planning, marketing and finance, may be required in different degrees at different points in the value chain. Transnational corporations that have adopted complex strategies have tended to alter their organizational structures accordingly. For example, many firms have moved from a horizontal, hierarchical structure towards a matrix structure, where reporting lines are often indirect and overlapping.

37. The internationalization of corporate functions is also present in the establishment by transnational corporations of decision-making authority for major business segments outside the parent corporation's home country. IBM (United States), for example, has located its networking systems headquarters in the United Kingdom; AT&T (United States) recently moved its headquarters for corded telephones to France; Hewlett Packard (United States) has located its desktop personal computer headquarters in France; while DuPont (United States) has two product headquarters in Switzerland and one in Japan. Hyundai (Republic of Korea) has established its personal computers headquarters in the United States. A number of European transnational corporations, including Asea Brown Boveri (Sweden and Switzerland), Siemens (Germany) and Unilever (Netherlands and United Kingdom), have established at least one global division outside of their home economies.

38. Some transnational corporations have established regional headquarters to manage regionally oriented networks. The primary function of regional headquarters is to provide coordination more efficiently than can be accomplished from more distant headquarters. The establishment of regional headquarters can be consistent with stand-alone strategies to the extent that those strategies have led to a concentration of foreign affiliates within a single region. More recently, however, the establishment of regional headquarters may have been a response to the rising degree of integration across affiliates within a single region. 27/ Thus, the growth of regionally integrated production networks in Asia by Japanese transnational corporations has been accompanied by an increase in the establishment of regional headquarters, especially in Singapore. The regional headquarters of Ford and

General Motors in Europe, although originally consistent with those firms' multi-domestic strategies, now manage complex intraregional production networks covering several models of automobiles; these include affiliates, subcontractors and firms linked through non-equity relationships. 28/

39. Among corporate-wide functions, there is evidence that transnational corporations have increasingly been locating a small but growing portion of their research-and-development activities outside their home country. One important motive is to take advantage of the skills available among technically trained people in host country locations. For example, IBM research on high-temperature superconductivity was undertaken in a facility located in Switzerland. The growing importance of research and development in production has also led to a greater portion of research and development being located near production facilities and near markets; as transnational corporations adopt complex international production strategies, they frequently adopt a more global approach with respect to research and development. Every Japanese automobile transnational corporation has established a design facility within the United States, in recognition of the importance of the United States market to their overall strategies.

40. Although organizational structures are supposed to carry out strategies, they can also be a hindrance to the effective management of corporate-wide strategies. Quite often, a particular organization or element of an organization is maintained, either due to inertia or because some decision makers judge it has not exhausted its profit potential. When that happens, organizational structures may help determine strategies, rather than strategies leading to changes in structures. In some transnational corporations, the attempt to establish complex international production strategies has been made difficult by the inability or unwillingness of many managers to adjust their thinking and behaviour from a home country or stand-alone structure. Monsanto (United States) moved the headquarters for its resins business to Belgium in order to be closer to its largest and fastest growing market - 50 per cent of Monsanto's world-wide resins business is in Europe. In addition, because many of its key corporate customers are transnational corporations with complex international production strategies, Monsanto felt that moving the division's headquarters would foster international integration and overcome the home country orientation prevalent in the parent company's headquarters. 29/ While establishing new structures can help overcome this, the disruptions caused by new structures may themselves lead to long-term inefficiencies. Linking strategies and structures is a complex undertaking that is not always managed successfully.

B. Non-equity arrangements and strategic alliances

41. The formulation of organizational structures to carry out the strategies of transnational corporations has become more complex with the growth of non-equity relationships. As a component of their complex international production strategies, transnational corporations have expanded their use of non-equity arrangements and in the process have created wider networks. Relationships between transnational corporations and their suppliers, subcontractors, licensees and franchisees have assumed greater importance in overall transnational corporation strategies. Many of these ancillary firms are

national companies, some are host country-based transnational corporations, while others are home country companies that often become foreign direct investors in order to maintain relationships established within the home country. These relationships have tended to assume a longer-term duration and parent transnational corporations to assume a more active involvement in the management of the ancillary firms. Thus, organizational structures need to encompass the activities of ancillary firms that are becoming more important to complex international production strategies.

42. A second set of non-equity relationships involves strategic alliances between two or more transnational corporations. Strategic alliances cover only a portion of a firm's activities, and a single transnational corporation may enter into strategic alliances with a large number of companies. In addition, alliances may be entered into with firms that are also competitors, establishing a complex relationship of simultaneous cooperation and competition. Strategic alliances have become increasingly important in high technology industries, such as computers, semiconductors, aircraft and telecommunications, where rapid technological change and rising development costs have created incentives for transnational corporations to seek alliances in order to share the costs and risks of new product development. 30/

43. Especially in the case of strategic alliances, but also in the case of subcontracting and other contractual relationships, the existence of these non-equity relationships raises important questions about how a transnational corporation organizes and governs its overall operations. Strategic alliances create relationships that are often blurred in terms of authority, with each party expecting to enhance the profitability of its ownership-specific assets or generate new ones. Alliance linkages tend to be horizontal rather than vertical and frequently require a rethinking of organizational structures. Such relationships also blur the traditional boundary lines of a firm, creating problems for many aspects of national regulatory policies. For example, cross-border alliances in high technology product segments have made the application of national security guidelines more difficult and are forcing many countries to re-evaluate such policies. 31/

C. Intra-firm resource flows

44. The expansion of complex international production implies an increase in cross-border, intra-firm activities and therefore an increase in the cross-border, intra-firm flow of resources. Relatively little data exist on intra-firm flows of resources. Available data on research-and-development outlays and patents suggest a growing role for transnational corporations in the international diffusion of technology. A number of transnational corporations have established cross-border networks for research and development, and data on research-and-development outlays and employment suggest that a small but growing proportion of the innovatory activities of transnational corporations takes place in host countries. 32/ Data on receipts and payments of royalties and licence fees for the United States, a measure of technology transfer, indicate that during the 1980s more than 70 per cent of receipts represented intra-firm transactions between United States parent transnational corporations and their foreign affiliates, while 50 per cent of payments represented intra-firm

technology-related transactions between the United States affiliates of foreign transnational corporations and their foreign-based parents. 33/

45. Evidence on intra-firm trade for United States-based transnational corporations also indicates growing cross-border integration. The share of foreign sales (sales by foreign affiliates located within host countries, including their exports from host country locations) represented by intra-firm transactions (between parent firms and their foreign affiliates and among affiliates) rose between 1982 and 1989, indicating a greater degree of integration within United States-based transnational corporations. 34/ If data for the petroleum industry are removed (since this industry was subject to substantial changes in national ownership and the mode of product delivery), the cross-border integration of United States-based transnational corporations grew from 1977 to 1989. This growth in integration was quite marked in transportation equipment, a category that consists largely of automobile production. It was also marked within the western hemisphere, especially with respect to Mexico, suggesting that a high and growing degree of regional integration had been established even before the opening of negotiations on the North American Free Trade Agreement (see table 2).

46. Data on intra-firm trade capture only one part of the degree of integration occurring within transnational corporation networks, since these data measure only visible flows between parent transnational corporations and their foreign affiliates, and among affiliates controlled by the same parent. Resource flows between parent companies or their affiliates and enterprises linked through non-equity arrangements are not adequately measured; such flows are a further indicator of the increased integration of international production. Available evidence suggests that the incidence of non-equity arrangements has been rising and that transnational corporations have utilized non-equity arrangements as an integral part of global production strategies. In addition, such data do not capture the (invisible) resource flows associated with various other functions of an enterprise, which are likely to grow as international production becomes more integrated.

Table 2. Integration index a/ for United States transnational corporations, by sector and host region, 1977, 1982 and 1989

(Percentage share)

	1977	1982	1989
Total	32	24	29
Total, excluding petroleum	25	28	32
Sector			
Manufacturing	30	32	36
Transportation equipment	45	52	55
Services	8	14	14
Region			
Latin America and the Caribbean	29	26	35
Mexico	20	27	67
Asia and the Pacific	51	35	43
Developed countries	23	22	27
Canada	42	31	38
European Community b/	24	22	26

Sources: Transnational Corporations and Management Division of the Secretariat, based on United States, Department of Commerce, U.S. Direct Investment Abroad: 1977 (Washington, D.C., United States Government Printing Office, 1981), tables III.H.1, III.H.2, III.H.6, III.T.1, III.T.2; United States, Department of Commerce, U.S. Direct Investment Abroad: 1982 Benchmark Survey Data (Washington, D.C., United States Government Printing Office, 1985), tables II.P.1, II.P.2, III.E.1, III.E.2, III.E.6; United States, Department of Commerce, U.S. Direct Investment Abroad: 1989 Benchmark Survey, Final Results (Washington, D.C., United States Government Printing Office, 1992), tables II.Q.1, II.Q.2, III.F.2, III.F.3, III.F.9.

a/ The integration index is calculated as the value of intra-firm international trade as a share of the value of sales by the majority-owned foreign affiliates of United States-based transnational corporations.

b/ Including 9 member countries for 1977, 10 member countries for 1982 and 12 member countries for 1989.

D. Emergence of an integrated international production system

47. The strategies adopted by transnational corporations and the organizational forms introduced to carry out these strategies are related to major changes in the world economy and to policies adopted by Governments of home and host countries. New technologies, growing demand for final output and the opening of larger portions of the world economy to movements in goods and services have been particularly important. In response to these changing conditions, transnational corporations have adopted strategies that seek to exploit their competitive advantages throughout the value chain and in a wide range of locations. These strategies have led to a greater functional interrelation among the elements of the value chain and across locations. At the same time, the growing importance of technology, organization and access to markets, areas in which transnational corporations possess particular advantages, have given these firms a growing role in world-wide economic change. The combination of the growing role of transnational corporations and the spread of their complex international production strategies has led to the beginnings of an integrated international production system. 35/

IV. IMPLICATIONS FOR DEVELOPING COUNTRIES

A. Developing countries and complex international production

48. A central feature of the emerging international production system is the importance of transnational corporations as the locus of various economic activities. This importance derives from the overall environment, particularly the role of technology and an open environment for trade and investment. Moreover, while the outlines of this new international production system indicate a substantial potential for affecting world-wide economic development, many countries and regions are participating only partially. Transnational corporations have been focusing primarily on establishing or strengthening their international production networks in the three regions of the Triad. Most developing countries have not been integrated into the evolving international production system. To the extent that an integrated international production system creates the primary impulses for global economic growth and development, both the role of transnational corporations and the contribution of countries and regions need to be fully evaluated.

B. Locational advantages of host countries under complex international production

49. Traditionally, transnational corporations locate within a host economy because the locational advantages of that economy, combined with the ownership advantages possessed by the transnational corporations and the advantages achievable through internalizing cross-border transactions, provide the most favourable environment for attaining strategic objectives. The most important locational advantages have been market size and growth, availability of skilled labour and/or low-cost labour, natural resources, infrastructure, a policy environment favourable to international production and proximity to other large markets. 36/

50. The growing scope for complex international production implies changes in the nature of the locational advantages that are most favourably evaluated by transnational corporations. As the entire value chain becomes a potential candidate for inclusion in complex international production, a wider range of corporate activities can be located in host economies. In principle, this gives host developing countries a better chance of matching their locational advantages with the needs of transnational corporations, as well as improving their chances of attracting a multiplicity of transnational corporation activities. In addition, as transnational corporations increasingly embody a complex package of attributes in their international production activities, they also require a differentiated package of locational advantages from host economies. So far, the newly industrializing economies in Asia have attracted complex international production activities because they offer growing markets, various levels of labour skills, favourable policy environments, efficient transportation and communications networks and access to a large and growing regional economy.

51. Among developing countries, the newly industrializing economies are likely to continue to have the greatest success in attracting foreign direct investment as part of complex international production strategies of transnational corporations. Other developing countries will continue to attract stand-alone affiliates, natural resource foreign direct investment or manufacturing and services outsourcing. However, unless they develop a wider range of locational advantages, most developing countries are likely to experience difficulties in attracting foreign direct investment in the higher value-added activities.

52. Two areas in particular stand out for developing countries seeking to attract those activities of transnational corporations most likely to contribute to national value added. One is to concentrate on improving human and physical infrastructure, including entrepreneurial and business skills, attributes of a national economy that are potentially attractive to transnational corporations, yet remain capable of being influenced by national policies. A second is to seek closer linkages with neighbouring economies, in order to generate larger markets and complementary locational advantages.

53. An additional consideration for host developing countries is the degree of integration of their policy frameworks. Policies related to international trade, human resource development, physical infrastructure, domestic capital formation, taxation and other areas are important to the attraction of integrated international production. As transnational corporations adopt strategies involving greater integration, host countries may also consider adopting a more integrated policy framework, as a means of ensuring consistency across the different policy arenas and focusing on attracting individual elements of complex international production carried out by transnational corporations.

V. CONCLUSION

54. As transnational corporations have been adopting new strategies and organizational structures, the functional and geographical scope of international production has been undergoing significant change. The evolution of the strategies of transnational corporations is far from complete; each of

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the major forms of strategy - stand-alone affiliates, simple integration and complex integration - is applied by transnational corporations in different circumstances. Indeed, each strategy may be employed within a single firm and it may be accurate to describe strategies at the level of the firm as representing a mix of the different forms. Nevertheless, there does appear to be a definite evolution of strategies towards those involving a more complex type of cross-border, intra-firm integration of the value chain over a wider geographical area.

55. The evolution of strategic possibilities is determined by changes in economic conditions, policy changes and developments in technology, especially information technology. Each strategy creates competitive advantages under certain conditions. As conditions change, transnational corporations have incentives to seek out new strategies and new organizational structures, in order to exploit more effectively the resources they control.

56. As new strategies and structures evolve, the nature of international production undergoes important changes. Locational advantages become more complex and interrelated, hence host economies, especially developing economies, need to evaluate and update their policy frameworks for attracting foreign direct investment and the activities of transnational corporations. In addition, organizational innovations on the part of transnational corporations can alter management methods and raise issues of governance that need to be addressed in the context of national and international regulatory frameworks.

Notes

1/ Official Records of the Economic and Social Council, 1992, Supplement No. 6 (E/1992/26), part two, para. 15.

2/ See, for example, Transnational Corporations in World Development: Trends and Prospects (United Nations publication, Sales No. E.88.II.A.7); World Investment Report, 1991: The Triad in Foreign Direct Investment (United Nations publication, Sales No. E.91.II.A.12); DeAnne Julius, Global Companies and Public Policy (London, Pinter Publishers, 1990).

3/ World Investment Directory, 1992: The Developed Economies (United Nations publication, forthcoming).

4/ World Investment Report, 1992: Transnational Corporations as Engines of Growth (United Nations publication, Sales No. E.92.II.A.19), chap. II.

5/ Ibid., chap. X.

6/ For analyses of strategies of transnational corporations, see Donald J. Lecraw and Allen J. Morrison, eds., Transnational Corporations and Business Strategy, The United Nations Library on Transnational Corporations (London, Routledge, 1993).

7/ For analyses of structures of transnational corporations, see Gunnar Hedlund, ed., Organization of Transnational Corporations, The United Nations Library on Transnational Corporations (London, Routledge, 1993).

8/ Alfred D. Chandler, Jr., *Strategy and Structure: Chapters in the History of the American Industrial Enterprise* (Cambridge, Massachusetts, The MIT Press, 1962).

9/ Richard E. Caves, *Multinational Enterprise and Economic Analysis* (Cambridge, Cambridge University Press, 1982), pp. 74-81.

10/ The classic statement of the economic rationale of the firm, originally published in 1937, is R. H. Coase, "The nature of the firm", in *The Firm, the Market, and the Law* (Chicago, University of Chicago Press, 1988), pp. 33-56.

11/ See John H. Dunning, "The eclectic paradigm of international production: a restatement and some possible extensions", in *Explaining International Production* (London, Unwin Hyman, 1988), pp. 41-70.

12/ Sunita Wadekar Bhargava, "Software from India? Yes, it's for real", *Business Week*, 18 January 1993.

13/ See, for example, Peter Dicken, *Global Shift: The Internationalization of Economic Activity* (New York, The Guilford Press, 1992).

14/ Theodore Levitt, "The globalization of markets", *Harvard Business Review*, No. 61 (May-June 1983), pp. 92-102.

15/ Kenichi Ohmae, *Triad Power: The Coming Shape of Global Competition* (New York, The Free Press, 1985).

16/ For an argument that the convergence of consumer tastes is incomplete, see Susan P. Douglas and Yoran Wind, "The myth of globalization", *Columbia Journal of World Business*, No. 22 (Winter 1987), pp. 19-29.

17/ *Multinational Corporations in World Development* (United Nations publication, Sales No. E.73.II.A.11), table 4, p. 138.

18/ "The universe of transnational corporations: report of the Secretary-General" (E/C.10/1993/11), table 1.

19/ These data are presented and analysed in *World Investment Directory, 1992 ...*.

20/ Geri Smith and John Pearson, "The new world's newest trade bloc", *Business Week*, 4 May 1992.

21/ For a discussion of regional core networks of transnational corporations, see *World Investment Report, 1991 ...*, pp. 44-53.

22/ *World Investment Report, 1992 ...*, pp. 32-46.

23/ John Hagedoorn and Jos Schakenraad, "The internationalization of the economy, global strategies and strategic technology alliances", *Nouvelles de la Science et des Technologies*, No. 9 (1991), pp. 29-41.

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24/ See, for example, Sylvia Ostry, "The new international order: the regionalization trend", paper prepared for the International Conference on the New International Order, Rio de Janeiro, Brazil, 13 and 14 April 1992.

25/ According to Peter Dicken, for example, globalization "implies a degree of functional integration between internationally dispersed economic activities"; globalization "is a more advanced and complex form of internationalization", which, in turn, involves "the increasing geographic spread of economic activities across national boundaries", Dicken, op. cit., p. 1.

26/ John Griffiths, "Toyota reveals names of key European car parts suppliers", Financial Times, 11 December 1992.

27/ John H. Dunning, "Multinational enterprises in the business services sector: a study in locational choice", op. cit.

28/ Peter Dicken, op. cit., pp. 298-303.

29/ Christopher Lorenz, "When head office goes native", Financial Times, 2 December 1992; Joann S. Lublin, "Firms ship unit headquarters abroad", Wall Street Journal, 9 December 1992.

30/ International Cooperation Agreements and International Mergers and Acquisitions in the 1980s: Central Measures in the Strategies of Transnational Corporations (United Nations publication, forthcoming).

31/ Edward M. Graham and Paul R. Krugman, Foreign Direct Investment in the United States (Washington, D.C., Institute for International Economics, 1991), especially pp. 149-155.

32/ World Investment Report, 1992 ..., chap. VI.

33/ Kan H. Young and Charles E. Steigerwald, "Is foreign investment in the U. S. transferring U. S. technology abroad?", Business Economics, No. 25 (October 1990), p. 29.

34/ A slightly different index of integration was developed by Stephen Kobrin; see "An empirical analysis of the determinants of global integration", Strategic Management Journal, No. 12 (1991), pp. 17-31.

35/ See World Investment Report, 1992 ..., chap. X.

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ROLE OF TRANSNATIONAL CORPORATIONS IN THE NEWLY OPENED ECONOMIES OF CENTRAL AND EASTERN EUROPE

Foreign direct investment in the newly opened economies of Central and Eastern Europe

Report of the Secretary-General

SUMMARY

Foreign direct investment (FDI) in the newly opened economies of Central and Eastern Europe (CEE), at its present level, remains a relatively recent phenomenon. The situation is rapidly changing, and all of the CEE economies are in the process of opening up and introducing domestic competition, which will render a great share of the economies' capital stock obsolete.

The potential role of FDI, economic policies adopted by Governments and the rebuilding of the capital stock of CEE economies will be decisive in their transformation to market economies. In the long term, the role of FDI in this process will be important. Together with commercial lending and official flows, FDI can be expected to make significant contributions to management and skill training, improving technology transfer, expanding export markets and developing new sectors of the economy.

While many CEE Governments have made considerable progress in the design and implementation of legal and regulatory frameworks to provide a more enabling environment for FDI, there remains a need to enhance domestic policy coordination, abolish the remaining restrictions on FDI and strengthen management capacity for the efficient implementation of policies and other measures now governing FDI. Overall inflows of FDI and maximization of its benefits will greatly depend on Governments' ability to implement programmes of macroeconomic stabilization and transformation of the economy, as well as the maintenance of social stability.

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* E/C.10/1993/1.

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INTRODUCTION

1. At its substantive session of 1992, the Economic and Social Council in its decision 1992/282 approved the provisional agenda for the nineteenth session of the Commission on Transnational Corporations and included in it an item on the role of transnational corporations in newly opened economies, with a report of the Secretary-General on this subject as documentation. The present report has been prepared in response to that request.

2. The notion of newly opened economies includes countries undergoing adjustments towards market-oriented structures. The Transnational Corporations and Management Division has been closely monitoring these developments and has been presenting its findings in United Nations publications, including the World Investment Directory, 1992, 1/ a report on foreign direct investment in China (ST/CTC/73), a report of joint ventures as a form of international economic cooperation (ST/CTC/93) and reports related to the conduct of international symposiums in Moscow (1991) on governance and structural transformation in transitional economies (TCD/SEM.92/12), and in Beijing (1992) on linkages of microeconomic reforms and macroeconomic adjustment in transitional economies. 2/

3. The present report addresses the main issues associated with foreign direct investment (FDI) in the newly opened economies of Central and Eastern Europe (CEE) 3/ as a result of the dramatic systemic changes in CEE countries, including the countries of the former USSR, during their transition from centrally planned to market-oriented structures.

4. Since the far-reaching changes of the late 1980s and early 1990s, the CEE region as a whole has been undergoing rapid development. Problems in the transition of the region to market-oriented structures remain considerable. The present report, based on information contained in four United Nations publications, 2,/ 4/, 5/, 6/ focuses on the general rather than the country-specific dimensions of FDI in the CEE economies. There are, however, important variations regarding all aspects of FDI among the individual CEE economies. 7/

5. The report analyses FDI within the overall macroeconomic, policy and regulatory context in which it is currently evolving. It provides a preliminary analysis of the recent role and impact of FDI on the ongoing reform processes; the analysis is qualitative rather than quantitative as the database on FDI in CEE economies does not allow for a detailed quantitative assessment of the impact of FDI. Also, limited experience has so far been gained with both the impact of FDI and the relationship between evolving policy, legal and regulatory measures, on the one hand, and trends in flows of inward FDI on the other. The report also outlines policy and technical assistance measures likely to maximize the positive impacts of FDI on the restructuring and transformation processes.

I. FOREIGN DIRECT INVESTMENT: STRUCTURE AND TRENDS

A. The foreign investor's perspective in a changing economic environment

6. The CEE economies, following the events of the late 1980s and early 1990s, found themselves in a very precarious state, with falling output, soaring inflation, widespread shortages and, in some countries, high levels of external debt. 5/ To prevent further economic deterioration and prepare for institutional reform, stabilization plans were implemented. The economic programmes adopted in all countries focused on institutional reform and stabilization, although detailed provisions of economic policy varied from country to country. Considerable differences in initial macroeconomic conditions and varying experiences of market reforms throughout the 1980s influenced the design and timing of reforms in individual countries. As a result, the CEE economies remain at different stages of transformation.

7. All of the CEE countries are in the process of transforming their economies from central planning to market allocation. The emerging pattern of transformation and restructuring seems to lead to the formation of two clusters of Eastern European countries: a comparatively affluent northern group comprising Poland, the former Czechoslovakia and Hungary; and a southern group comprising Albania, Bulgaria and Romania. Within the former USSR, similar trends appear to be developing with the Central Asian republics lagging behind the European republics of the Commonwealth of Independent States.

8. While there are very few signs of economic recovery, industrial production in Poland, the former Czechoslovakia and Hungary stopped falling during the second half of 1992. The major economic indicators point to continued recession in Romania, Bulgaria, Albania and the former USSR. The growth of private business, especially small- and medium-sized retail companies (shops, restaurants and services), contributed considerably to the economic recovery in some countries. These companies are responsible for breaking the fall in Polish production, rapid growth in Hungary's trade with the European Community countries and falling unemployment in the former Czechoslovakia. 8/ However, levels of output in 1991 were no higher than 10 years ago and domestic capital investment fell to the levels of the middle 1970s. The last three years have witnessed such deep cuts in investment outlays that even essential maintenance has been delayed or neglected, threatening much of the viable capital stock. Industrial production has been especially hard hit. The collapse of trading relationships sponsored by the Council for Mutual Economic Assistance had a negative impact on production for exports. While the radical elimination of import barriers stimulated production in some countries, import restraints, induced by currency shortages, deprived industry of necessary raw materials, equipment and replacement parts. In the former USSR, this is especially the case in the food, pharmaceutical, textile, garment and footwear sectors.

9. The structural roots of the CEE economic crisis suggest that several CEE economies will continue to experience macroeconomic disequilibria for some time to come. Even assuming favourable external factors and domestic reforms, the time it will take to catch up with market economies and reach levels of income comparable to those of the industrial countries will certainly be measured in decades rather than years. Growth prospects in the CEE economies will depend

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largely on their ability to attract FDI but equally on their ability to renew fiscal balance; control external payment and trade balances and inflation; strengthen economic, legal and financial institutions; and establish privatization. The course of economic transition will also be critically determined by political factors in most countries. Whatever the economic policy targets adopted, the major issue is credibility and business confidence. It is these factors which will determine inflows of FDI and encourage domestic private saving and investment, which are key elements for any successful economic transformation and macroeconomic stabilization.

10. FDI is a relatively recent phenomenon in CEE economies. It was only during the 1970s and 1980s that CEE countries began to gradually open up to FDI. Towards the late 1980s, with increased liberalization of foreign-direct-investment policies, inward FDI grew rapidly in terms of number of investments and value of foreign equity participation. However, in terms of overall capital flows, FDI is unlikely to play as large a role in the short to medium term as was widely expected at the start of the reform process. 9/ In some countries, investors remain reluctant to risk substantial equity commitment, given the current uncertainties, while on the domestic side there is reluctance in some countries to sell local assets of a previously public sector activity to foreign interests. 10/ FDI investment in the CEE countries must be analysed from a long-term rather than a short- or medium-term point of view.

11. The CEE countries seek FDI for various country-specific reasons. The promotion of FDI is a strategy component of overall economic restructuring, trade and privatization policies. FDI is expected to contribute to: (i) acquisition of new capital; (ii) acceleration of economic restructuring; (iii) technology transfer; and (iv) diffusion of management and marketing skills. 11/

12. While most companies that invest in CEE are attracted by the potential of both domestic and regional markets, some companies also consider the region as an extension of EC countries and are establishing production facilities there with a view to supplying the entire European market. 12/ In non-sensitive industries, a number of European, United States and Japanese companies have established plants in Central and Eastern Europe to supply both domestic and foreign markets. Although benefits to existing investments may not materialize in the short to medium term, it is the advantages associated with being first in market entry and long-term growth prospects that are leading companies to invest in the CEE.

13. At this stage of the transition process, the major and catalytic benefits of FDI relate to the provision of management expertise, familiarity with export markets, access to advanced technology and the opening up of new sectors of the economy. Macroeconomic stabilization and the creation of an enabling socio-economic environment, including the development of well-structured legal and regulatory frameworks and the institutions required to support and implement them, will be the major determinants of the growth of both foreign and domestic private investment.

14. In spite of the comparatively small size of investment flows, FDI has the potential to make a significant contribution to the economic restructuring process and reintegration of the CEE economies into the world economy through

the diffusion of management and marketing skills, the transfer of product and process technologies and the generation of positive spill-overs by overcoming the informational costs of entering world markets. However, FDI has to be viewed as complementing commercial lending or official flows. 13/

B. Inward foreign direct investment

15. The amounts actually invested in CEE countries remain small by international standards, as is the size of the average investment. In Poland, for example, joint ventures account for less than 5 per cent of exports, less than 3 per cent of sales and less than 2 per cent of employment. Although the size of the average foreign capital per joint venture is somewhat larger in Hungary, the average amount of this capital, mostly from Germany, Austria, the United States and Switzerland, is still generally small, usually less than half of total capital of joint ventures. Investors, in some countries, remain wary of the political and economic risk and the uncertain legal and procedural frameworks.

1. Overall trends 14/

16. There has been a strong growth in FDI flows to CEE countries, most notably to Hungary, former Czechoslovakia and Poland. After starting at a comparatively low level, the growth of FDI appears impressive but is often attributable to individual, large-scale, multi-year projects. 1/

17. Net inflows of FDI into Poland accelerated from $105 million in equity capital in 1990 to $323.5 million in 1991 and an estimated $1 billion in 1992. The FDI inflow into Hungary for 1991 amounted to $680 million by the end of August of that year. Bulgaria reported a sharp increase in net inflows from $4 million in 1990 to $24 million during the first six months of 1992. FDI inflows into Romania accelerated to an estimated $270 million in 1992, compared with $156.3 million in 1991.

18. Between 1991 and 1992, the number of foreign investment projects registered in Romania increased from 1,589 to 20,749. In Poland, there were 4,900 registered foreign investment projects in 1991 and an estimated 9,000 in 1992. It should be noted, however, that in many countries only a fraction of the registered investment projects are operational. In addition, the countries at a more advanced stage of transformation, notably Hungary, former Czechoslovakia and Poland, have attracted the bulk of FDI in the region. Albania, Bulgaria and Romania continue to lag behind in terms of total value of FDI.

19. In Hungary, the number of registered joint ventures and wholly foreign-owned subsidiaries grew from 5,100 at the end of 1990 to an estimated 13,100 by 1 August 1992. Invested foreign capital amounted to $4.85 billion in October 1992. Approximately one quarter of all new business ventures established during 1990 had foreign participation. This share, however, gradually diminished, reaching one fifth in 1992. Accumulated foreign investments, at the end of 1992, represented approximately 8 per cent of the fixed capital of the Hungarian company sector. Even under conditions of

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considerable economic and political uncertainty, Hungary attracted important amounts of foreign capital.

20. FDI has also significantly increased in Poland. Only 13 projects were authorized in 1987 and 40 in 1988, but by 15 June 1991 some 4,350 foreign investment projects had been authorized; by the end of 1992 an estimated 9,000 joint ventures had commenced operations and this number is estimated to be on the order of 5,000 by the end of 1992. The estimated value of investment commitments was $3.26 billion by the end of 1992.

21. In Romania, the first half of 1992 witnessed the appearance of significant structural change in FDI. FDI moved from predominantly small-scale investments in such areas as retail trade to medium and large-scale FDI in the productive sectors of the economy and came from such companies as Shell, Amoco Petroleum, Enterprise Oil, Siemens, Alcatel CIT, Asea Brown Boveri and Coca-Cola.

22. In Bulgaria, an estimated 800 joint ventures were registered with cumulative investments of $300 million by 1 October 1991. However, net inflows of FDI remained about 10 times less than in Hungary. In Albania, an estimated 86 joint ventures, with a foreign equity participation of some $10 million, were registered as of 1 November 1992. In former Czechoslovakia, compared to some 204 joint ventures registered in 1989 and 740 registered joint ventures in 1991, an estimated 1,900 joint ventures were registered by December 1992.

23. In the former USSR, emerging States have created a variety of vehicles for foreign investors. However, as in the other CEE economies, joint ventures continue to be the most popular form of investment. Joint ventures became legal only in January 1987; by 1 January 1992, some 5,000 joint ventures had been registered by Goskomastat. The Russian Federation hosted the most joint ventures through October 1991. Subsequently, during the period from March to November 1992, 3,559 joint ventures, with equity capital on the order of $174 million, were registered, as well as an additional 704 companies that are wholly foreign owned, with a total capital committed of R 2,436 million. Central Asia has been the least popular region, although the number of joint ventures in Uzbekistan grew rapidly during 1991 and Chevron and Elf-Aquitaine announced major petroleum projects in Kazakhstan during 1992. Figures for Latvia and Estonia, as of 1 July 1991, indicate that they have outpaced all the former Soviet Republics with the exception of the Russian Federation and Ukraine. A 1992 World Bank report estimates that total foreign investment in the former USSR was on the order of $1.5 billion; 15/ on the basis of actually operating joint ventures, it is estimated that gross foreign direct investment in the Russian Federation totalled $1.2 billion by the second quarter of 1992.

2. Countries of origin

24. European investors, in general, are the most active joint venture partners in CEE economies. According to 1991 Economic Commission for Europe data, European investors, in value terms, are most significant in Albania (90 per cent) and Poland (80 per cent). The corresponding shares are 68 per cent in the former USSR, and 55 per cent in former Czechoslovakia.

25. This situation, however, is changing rapidly. It can be expected that FDI inflows will continue to originate primarily from the economies of the Triad, that is, Western Europe, the United States and Japan, but in the former USSR, in addition to the Triad, Turkey and the Republic of Korea are also active investors and approximately 20 per cent of the value of FDI in the former USSR emanates from developing or CEE countries.

3. Sectoral distribution 16/

26. FDI in the former USSR, Hungary and former Czechoslovakia is concentrated in the manufacturing sector in terms of capitalization of joint ventures. The sector's share by numbers is less pronounced. In other sectors, particularly in business services, such as management of real estate, rental and leasing of machinery and computer-related services, investments are smaller per venture; however, they are higher when measured in number of investments.

27. Trade operations, including foreign trade, account for 20 per cent of all foreign investment projects in former Czechoslovakia and Poland and for 22 per cent in Hungary. In addition, 90 per cent of joint ventures and wholly foreign-owned subsidiaries in Romania indicate trade as one of their activities. In the former USSR, investment in trade activities has remained insignificant until recently, because of restrictions imposed on such ventures.

28. Other sectors of the economy attract comparatively few investments. Construction accounts for about 5 per cent of joint ventures in the former USSR and former Czechoslovakia and about 6 per cent of joint ventures in Hungary. FDI in agriculture, forestry, fishing and mining has remained insignificant. The highest shares in agriculture have been reached in former Czechoslovakia and Poland. Hotels and restaurants are an important sector for FDI in the former USSR.

4. Geographical location 17/

29. FDI typically remains concentrated in the capital regions of CEE countries. Some 55 per cent of joint ventures in former Czechoslovakia are located in Prague and Bratislava. In Hungary, the bulk of joint ventures are located in Budapest and the north-western part of the country. In Poland, however, only 25.6 per cent of joint ventures are located in Warsaw. In the former USSR, 48 per cent of all joint ventures registered by 1 January 1991 were located in Moscow. St. Petersburg and its region accounted for 9.5 per cent of all registered joint ventures. In Albania, more than 60 per cent of all joint ventures are located in Tiranë.

30. This concentration of joint ventures in the capital regions clearly indicates that more advanced infrastructure and access to administrative centres are determinants in locational decision-making. In the case of consumer goods, it is proximity to the relevant markets which is crucial in locational decision-making.

C. Outward foreign direct investment 1/

31. The growth of outward FDI is a further important dimension of the integration of CEE economies into the world economy. By the late 1980s, an initial network of branches, subsidiaries and affiliates had been established. The nature and levels of outward FDI differ considerably among CEE countries. Evidence points to a long-term growth of outward FDI, especially in developed countries, in the form of both new investments and further development of existing investments. The growth of foreign affiliates has led to an expansion of supporting facilities, such as regional offices and retail networks in host countries, as well as the establishment of new branches and subsidiaries. While the immediate problems related to transition in the CEE countries may well result in a temporary deceleration of outward investment activity, in the long run the need for close linkages with Western Europe and integration into the world economy will induce the direct presence abroad of CEE enterprises.

32. Most CEE outward FDI occurred over the past two decades as mounting hard-currency trade deficits and international indebtedness required increasing foreign exchange earnings through export expansion. From 1980 to 1990, total capital committed by CEE companies and joint ventures located in developed market economies amounted to $334 million, raising the total to $1.4 billion committed, with $1.2 billion operational.

33. In contrast to inward FDI, where the foreign share is most often 50 per cent or less, outward FDI tends to be more clearly controlled by home-based investing enterprises. In at least two thirds of the cases recorded at the end of 1990, CEE corporations held 50 per cent or more of the equity in their foreign affiliates. A preference for majority ownership was especially clear in the case of the former USSR. The majority of foreign affiliates are directly involved in the import and distribution of manufactured products in developed market economies. Hence, a majority of CEE investments is concentrated in Western Europe, which constitutes the principal market area for the CEE countries.

34. The sectoral distribution of outward FDI reveals a dominance of tertiary sector operations. While these are predominantly commercial, finance and transport are also important services sector activities for investment. Others include construction and tourism. Primary and secondary activities are typically more important as investment-receiving sectors in the developing countries.

II. POLICY, LEGAL AND INSTITUTIONAL FRAMEWORKS

35. The CEE countries began to pursue policies aimed at establishing links with the world economy only in the late 1960s. Policies included the promotion of "international inter-enterprise cooperation". Some countries also included promotion of joint ventures in approved forms of economic cooperation. Foreign direct investment was increasingly accepted as a means of advancing the "scientific technical revolution" through the acquisition of otherwise unobtainable foreign technology and know-how. The characteristic approach was to allow FDI under rather restrictive conditions with two important limitations: (i) foreign capital participation was allowed only in partnership with a host

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country organization and was limited to a minority share (49 per cent maximum); (ii) foreign capital was restricted to selected industries of the host economy (for example, it was excluded from capital goods production and consumer services, as in Hungary in the 1970s, or was limited to small-scale production, as in Poland in the late 1970s and early 1980s).

36. Mounting economic difficulties during the 1980s led to renewed interest in FDI. Economies experiencing large debt accumulation to Western creditors began to view FDI as a source of hard currency and a channel through which to acquire technology, develop human resources and restructure their economies. While the reform and transformation processes initiated in the late 1980s have contributed to removing long-standing institutional barriers to the integration of more substantial amounts of FDI, the rapidly changing and uncertain conditions of transition and reform make it difficult to attract desirable levels of FDI inflows. The following variables and their interaction will be crucial in attracting FDI: (i) legal and regulatory conditions; (ii) economic conditions; (iii) political conditions; and (iv) institutional conditions.

A. The policy framework

37. While CEE countries display marked differences in their initial socio-economic situation and the scope and pace of their institutional reforms and political environment, all of the CEE countries follow broadly similar paths of transformation. In 1991, three basic phenomena could be identified which were common to all of those countries: (i) they were engaged in the process of implementing comprehensive reform-cum-stabilization programmes (although the designs of the programmes and the degree of implementation differed considerably); (ii) they have all been in deep recession; and (iii) the early results of reforms, in most countries, have been less favourable than was initially anticipated.

38. Furthermore, the expected role of foreign capital in the transition process is far from clear. To date, either policy decision-making remains fragmented or important policy issues, regarding, in particular, the degree of government control or management of FDI, the preferential treatment of foreign investors as compared to domestic investors, and the liberalization of capital markets and cross-border capital, have not been explicitly addressed. Moreover, regarding the privatization process, it has not yet been clearly decided whether foreign direct investment should be encouraged by admission to the divestment process. The CEE countries, where they have formulated policies, have taken widely differing approaches to this policy issue. 18/

39. Government official economic policy documents all underline the importance of FDI in economic development. In Hungary, for example, the explicitly stated government target for FDI is to reach a stock of US$ 8-10 billion by the end of 1993, amounting to a 20 to 25 per cent share of foreign ownership of industrial capital. Sectoral development and restructuring policies and strategies, however, do not explicitly incorporate FDI. Given the importance of regional industrial development in the regeneration of economic growth, it is surprising that there is generally no explicit and comprehensive spatial policy or strategy regarding in-country location of FDI.

B. The legal and regulatory framework 1/

40. The rapidly changing circumstances in which policy makers have had to work out new legal frameworks and their relative inexperience in FDI regulations have resulted in ad hoc, piecemeal approaches, in particular in the former USSR. The instability and lack of transparency in legal conditions governing FDI, including the issue of property rights, constitutes in itself a major deterrent to FDI.

41. The most significant developments in establishing legal and regulatory frameworks governing FDI at the domestic level pertain to: (i) entry procedures; (ii) right of establishment; (iii) repatriation of profits and capital investment; (iv) foreign investment taxation and double taxation agreements; (v) ownership of land; (vi) privatization of State-owned enterprises; (vii) currency conversion; (viii) intellectual property rights; and (ix) introduction of international accounting systems. Furthermore, all of the Central European countries, with the exception of Albania, have signed trade and cooperation agreements with the European Community. The Central European countries have also negotiated second generation agreements of association with the European Community. All of the CEE countries now belong to major international economic organizations such as the World Bank, the International Monetary Fund and the General Agreement on Tariffs and Trade, or have indicated a desire to join. These developments were accompanied by various measures to strengthen investment incentives and guarantees, including the negotiation of bilateral investment protection treaties.

42. The majority of CEE countries has a very progressive attitude towards FDI, especially in the area of FDI legislation. Regulations and laws implemented so far all recognize the importance of FDI and the need for basic legal clarity and stability of FDI policy. Much work, however, remains to be done to achieve a broader standard of reliance on laws and the normative functions that they set. There are numerous laws which can affect the behaviour of FDI, ranging from investment protection to intellectual property protection. The present state of FDI legislation is characterized by provision of laws concerning: (i) licensing or the structure by which FDI can participate; (ii) legal protection from expropriation and forms of compensation for expropriation (investment protection); (iii) some form of repatriation of profits if permitted; (iv) certain restrictions of FDI in specialized State-protected industries; (v) import/export legislation, free economic zone development and certain tax incentives as well as joint-venture legislation; and (vi) specific regulations governing the use of hard currency and forms of currency conversion.

43. Under earlier laws governing enterprises with foreign participation, a foreign enterprise was required to obtain authorization from the Government to establish a foreign affiliate. This presented the investor with certain problems relating not to the authorization itself but to the conditions under which it was granted. Applications had to be accompanied by considerable documentation. A feasibility study of the proposed investment project was often mandatory and approval was required from several agencies and ministries. In Albania, Bulgaria, former Czechoslovakia, Hungary and Poland, the need for government approval has now been either partially or totally removed. In those countries in which permission is still required, approval procedures have been shortened and simplified. In Romania, for example, only one agency, the Romanian Development Agency, is responsible for issuing consent and applications are required to be processed

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within 30 days. In some countries, however, the legislative process regarding approval and registration of FDI remains time-consuming and lacks transparency.

44. Foreign enterprises, under previous legislation, were often excluded from certain industries, such as banking and financial services, and from engaging in foreign trade and fully owning their business. In addition, they were often obliged to invest a minimum sum in the foundation capital of a foreign affiliate. Domestic legislation now provides for national treatment of FDI. In some instances, notably in trade, foreign investors have acquired rights superior to those of domestic enterprises. In other cases, however, legislation continues to exclude foreign investors from particular industries. This is the case in some of the new independent States, for instance, Belarus.

45. Foreign investors in Hungary, Poland, Romania, former Czechoslovakia and to some extent Albania are allowed to repatriate all their profits in convertible currencies, including proceeds from the sale of their original capital investment. Prior to the introduction of internal convertibility, foreign investors were restricted in the amount they could repatriate and were often forced to use a complicated system of barter in order to repatriate profits from their activities. For example, until June 1991, remittances of dividends from investments in Poland were restricted to the surplus of export earnings over imports generated by a foreign affiliate, plus 15 per cent of net profits derived from sales in the domestic markets.

46. Foreign investors pay taxes in the CEE countries but historically rates have been much lower than those paid by domestic firms. The easing of restrictions on profit repatriation in some countries has generally led to a less favourable fiscal treatment for foreign investors. In general, fiscal incentives are now awarded more selectively. This approach, designed to ensure that domestic enterprises are not placed at a competitive disadvantage vis-à-vis their foreign counterparts, may create a degree of confusion for investors about whether they qualify for special treatment. In Hungary, legislation lists in detail the precise industries in which investors qualify for incentives; in Poland, legislation introduced tax incentives for those investors with more than 2 million European currency units (ECUs) capital investment or those who locate their investments in regions of high structural unemployment.

47. The acquisition of land and buildings by foreign physical or legal persons is a sensitive issue in CEE economies. In particular, corporations may wish to acquire land where investments require acquisition of large land surfaces, or they may wish to purchase land for purely commercial reasons. Land also serves as a collateral when raising commercial loan funds. The legal provisions regarding land ownership in some of the CEE countries are complex and remain in transition between the previous system of collective socialist ownership and the new property legislation enacted in response to the needs of a market economy. At present, property laws in some countries of the region either prohibit foreign ownership of land or fail to provide clear title to a property or its unrestricted transfer from one enterprise to another. In addition, arrangements allowing foreign investors to lease land may be of too short a duration. Lithuania, for example, only permits foreign investors to lease property for 25 years. In Poland, land management law sets out provisions for the sale, use and lease or rental of land owned by the State Treasury or communes to foreign subjects upon consent of the Minister of

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Internal Affairs, who is required to submit annual reports to Parliament regarding the sale of land to foreigners.

48. Of equal importance for FDI are laws regulating the transfer of ownership of State-owned enterprises and their assets from the State into private hands. Since the early 1990s, ambitious privatization programmes have been pursued in the CEE countries in which FDI is likely to play an important role. All CEE countries have introduced laws to guide the privatization process, including the creation of government agencies to overview the process and facilitate the technical procedures of the transfer. These laws principally allow for the acquisition by foreign investors of majority stakes in former State-owned enterprises, although restrictions can be found in areas considered sensitive by Governments, such as defence and mining. However, CEE countries differ significantly when it comes to implementation. While all CEE countries have enacted privatization laws, only three countries (Hungary, Poland and former Czechoslovakia) have established the legal preconditions for privatization (for example, property, bankruptcy and securities laws) and sufficiently advanced procedures for implementing such schemes. In former Czechoslovakia, Romania and the Commonwealth of Independent States, a large-scale privatization law has been adopted to promote a mass privatization scheme through the implementation of a voucher system. In other countries, privatization has a more gradual character and so-called small privatization efforts, such as restaurants and shops, have been implemented on a large scale.

49. The foreign purchase of corporate equities may replace joint ventures as the principal vehicle for investment in several countries. Some of the legislation on privatization restricts the right of foreign enterprises to acquire State-owned enterprises. In Hungary and former Czechoslovakia, foreign investors are excluded from participating in small privatizations. It would appear that the early experience of the sale of State-owned enterprises in the CEE countries, the so-called spontaneous privatizations, in the course of which some companies were allegedly sold to foreign investors at discount prices, has encouraged all the countries of the region to ensure that sales to foreigners are properly regulated by the State.

50. Government initiatives to promote FDI have not been confined to reform of national legislation. In particular, the CEE countries have concluded numerous bilateral investment protection treaties. Former Czechoslovakia, for example, concluded 13 such treaties between 1989 and 1991 in order to provide investors with a supplementary level of legal protection. International guarantees that protect investors against harmful acts by the State, including expropriations, are particularly important for foreign investors wishing to invest large amounts of capital in the CEE region. Given these countries' political instability, foreign investors often consider the guarantees that the domestic law provides on such matters as insufficient. 19/

C. The institutional framework

51. At present, the remaining institutional and ideological legacies of centrally planned systems constitute major obstacles to FDI. These include the weakness of core market-oriented institutions both inside and outside of Government. 20/ Legal institutions and accounting standards were weak and did

not conform to those generally accepted in market economies and there was no tradition of independent audits. State-owned enterprises were profoundly shaped by central planning and therefore lacked marketing and strategic planning capabilities and effective inventory controls. They had little or no information on the relative profitability of the various products they were required to produce. Most CEE Governments had little expertise in indirect regulatory instruments, such as monetary policy, taxation, competition policies and the supervision of financial institutions. Hence, there is a need in all of the CEE economies to re-establish market-based institutions and build the associated skill base.

52. Governments have essential functions in market economies, including the provision of infrastructure, legal and regulatory frameworks, correction for monopolies, "externalities" such as environmental costs, and the provision of basic social services and a safety net to alleviate hardship through the collection of taxes and other levies. The CEE Governments face daunting institutional challenges as they attempt to redefine and reorient their role to meet the requirements of a market economy. Not only must they either upgrade or establish new administrative structures of governance, but in many cases they need to reduce their overall size, retrain many civil servants and, if possible, maintain or augment a small cadre of well-qualified policy analysts and decision makers. They also face politically sensitive questions concerning decentralization to regional and local levels.

53. Most CEE Governments have either downgraded or abolished their former planning offices, have consolidated single-industry ministries into a smaller ministry of industry and have established privatization agencies. Many Governments are in the process of setting up training programmes for civil servants, often with international assistance. However, it will require considerable time to re-establish market-based institutions and build the associated skill base. Often, there is a need to educate and train thousands of accountants, bank staff, regulators, lawyers, investment bankers, brokers and others with related skills. 21/

54. The institutional framework for FDI varies from country to country. In Poland, the Ministries of Privatization and Finance and the State Foreign Investment Agency are all directly concerned with FDI. Their activities are coordinated at the level of an advisory committee directly under the Council of Ministers. In Albania, the Foreign Investment Agency, under the Ministry of Trade and Foreign Economic Cooperation, is directly concerned with FDI. There is also a Department of Foreign Investment in the Ministry of Finance and Economy, as well as in other sectoral ministries. In Hungary, the main institution directly concerned with FDI is the Foreign Investment and Trade Promotion Agency of the Ministry of International Economic Relations. Decisions concerning the granting of investment support through the Investment Promotion Fund are made at inter-ministerial committee level. A further inter-ministerial committee is responsible for FDI strategy formulation. FDI promotional activities also vary from country to country. They typically involve the conduct of international investors' conferences and the operation of trade representation bureaus.

III. SOME POLICY IMPLICATIONS

A. The potential role of foreign direct investment

55. The lack of accurate data makes it difficult to assess in any degree of detail the quantitative impact of FDI. The most comprehensive FDI data available concern the number of affiliates established. Data on the value of FDI and industrial activity are often fragmentary in nature. Moreover, details on even the largest investments are not made available on a systematic basis. 1/ Also, a considerable number of small-scale joint ventures avoid statistical measurement. Generally, the contribution of FDI in the transition process has been rather marginal in overall economic terms.

56. In some CEE economies, FDI is beginning to play a role but it is difficult to calculate the ratio of FDI flows to gross domestic capital formation. By using International Monetary Fund data, it is estimated that this ratio was 0.5 per cent for the former USSR in 1989 and approximately 8 per cent for Hungary in 1992. The significance of the impact of FDI varies among countries and sectors. Employment in enterprises with foreign capital participation would also appear to generally remain insignificant in terms of its contribution to total employment. The share of enterprises with foreign capital participation in total exports, as well as their share in total imports, is also generally limited. In Hungary, however, enterprises with foreign capital participation contribute 10 per cent to total employment creation and account for 25 per cent of total exports. FDI is also an important factor in industries such as automobiles, paper, printing and publishing, and some food products. In some countries, FDI has begun to play an active role in high technology industries such as information and communications technology.

57. The capital stock of most CEE economies is old and largely obsolete. Energy intensity in production is several times higher than in countries that are members of the Organisation for Economic Cooperation and Development. Production structures are largely biased towards producer goods industries (steel and non-ferrous metallurgy, machinery, oil refining, chemicals) in which many enterprises are internationally uncompetitive and supply is widely inconsistent with the demands of the domestic market.

58. All CEE countries experience a high level of pollution, which compromises public health and imposes considerable economic losses. Much water is unfit for human consumption and large forest areas have been irreversibly damaged. The Government must take the leading role in promoting environmental clean-up by changing economic incentives, imposing regulations and setting clear standards and targets. The amount of capital required for environmental clean-up is far beyond the financial resources likely to be available. 22/ FDI cannot be expected to become the driving force in the transition to environmentally sound growth but it can play a critical role in the transfer of: (i) environmentally sound production technologies; and (ii) environmentally sensitive and sound business management.

59. The scarce management factor might well prove to be the initial most pressing bottleneck factor in the transition of CEE economies to market economies. FDI already plays an important role in the transfer of management

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and organizational techniques and skills by providing (i) a model for operations in the host-country and on-the-job training; and (ii) formal management training programmes and international exchange programmes. In some countries, foreign investors have also participated in the establishment of several management schools.

60. The opening up to FDI and international trade creates opportunities not only for accelerating the restructuring process of a widely obsolete capital stock but also accelerates technology transfer. All the CEE economies recognize the need for improving technology transfer through the promotion of FDI. At this stage, there is no readily available comprehensive information or data on the magnitude or sectoral composition of the impact of the activities of transnational corporations on technology transfer, other than in the area of "soft" technology, such as computerization.

61. FDI will have a considerable impact on the opening up of export markets and thus the integration of CEE economies into the global economy through the well-developed information networks on international markets that FDI can access. In 1990, 16 per cent of Hungary's exports originated from joint ventures. In 1992, it is estimated that some 25 per cent of exports originated from joint ventures. Methodological and other problems, however, make it extremely difficult to measure the impact of FDI on individual countries' balance of trade.

B. Foreign direct investment prospects

62. The CEE countries all have the comparative advantage of a highly educated labour force and in some cases are rich in natural resources. At this stage, however, it is not clear to what extent sufficient momentum for both privatization and FDI can be built up. FDI can contribute decisively to economic growth and trade in this critical period of transition for the CEE economies. However, there remains a need to improve conditions for FDI in the CEE economies. Sound macroeconomic policy, appropriate exchange-rate policies, trade policy and capital market liberalization will be factors determining the inflow of FDI. In addition, there is a need to implement mutually reinforcing and comprehensive privatization policy; trade and anti-monopolization or anti-trust policy; and foreign investment policy. Further, important policy issues concerning short-term profit-taking FDI need to be addressed. It may be that, in the initial stages of the opening-up and transformation process, a relatively flexible policy towards such forms of FDI is preferable in order not to discourage long-term, strategic FDI.

63. Furthermore, the promotion of FDI by the CEE economies is taking place at a time when the fundamental determinants of FDI and the structure of international investment flows are subject to significant changes. At the global level, although FDI flows have grown since the beginning of the 1980s, private sector funds available for investment are not expected to expand significantly in the near future. 23/ Favourable FDI regulations *per se* do not induce urgently needed capital flows. Relatively liberal FDI regimes are a necessary but not sufficient condition for FDI. It is the overall political and economic environment, including the nature and level of structural strengths and weaknesses of a host country, which are of greatest importance.

64. In the short term, the locational advantages for FDI in CEE economies remain comparatively limited in view of the global competition for capital inflows. The physical infrastructure of these countries is weak, income levels lead to low domestic demand and, with the exception of Poland, Ukraine and the Russian Federation, national markets are comparatively small.

65. In general, FDI flows to readily accessible infrastructure services as well as preferential treatment. Hence, there is a need for: (i) improving overall infrastructure availability and its quality; (ii) enhancing the involvement of regional and local Governments in the process of attracting foreign investment; and (iii) in some countries, implementing such specific FDI promotion strategies as the setting up of free economic zones.

66. The lack of regional specialization is clearly visible in the CEE region. To promote FDI, it may be advantageous to develop in the long term new approaches to regional integration, free trade and intra-industry trade and in the short term to harmonize privatization, trade and foreign investment policies among CEE countries. Considering the rapidly evolving and changing political, economic and social circumstances in many CEE countries, it is somewhat hazardous to make any projections regarding the prospects for FDI. However, once the most favourable FDI opportunities have been exploited, it might be difficult to sustain high FDI inflows even under optimal circumstances.

C. International cooperation in the promotion of foreign direct investment

67. There is a continued need for international cooperation in assisting Governments in making the transition to a market economy and strengthening their FDI management capacity. It is important to recognize that international, multilateral, regional and governmental financial institutions and other country-sponsored private sector and government programmes have a significant role in supporting FDI. Such organizations promote a degree of financial and political risk-sharing with the prospective investor and thus contribute to creating confidence. These organizations, furthermore, provide excellent terms for financing specific projects and ventures. Some provide political-risk insurance and also lead private-sector investment missions, thus promoting closer cooperation between private investors and the host country. These organizations have generally become a reliable source of information on specific projects and investment climates.

68. Many multilateral and international organizations involved in promoting and supporting transitional economies have representative offices in the host country and take an active role in advising host Governments in the legal and economic reform process. Most important, in order to accommodate financing available from these organizations, both the investor and host country must meet certain criteria and standards. Such organizations thus play a significant role as financial and legal investment catalysts for the private sector. They can act as the facilitator and initiator of interest, a role in FDI promotion that is sometimes overlooked.

69. Recognizing that management and entrepreneurial capacity development, together with the promotion of FDI, will play a key role in the process of

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transition from centrally planned to market-oriented economies, the Department of Economic and Social Development of the United Nations Secretariat, through its Transnational Corporations and Management Division, has designed a programme of integrated technical assistance and human resource development aimed at strengthening national capacities for the effective assimilation of FDI. 24/

70. This integrated programme has three major components. The first involves building a managerial infrastructure for local economic activity and future business, including training of staff in Government and the public and private sectors dealing with various issues relating to FDI. Special attention is given to the development of international accounting in these countries. The second component involves entrepreneurial development: the nurturing of local enterprise through business skills development, technical training and ongoing support of new enterprises. The culmination of this process will be the creation of a national coalition of local businessmen, entrepreneurs and government officials to continue and expand the enterprise creation process. The third component involves regulatory and institutional development in the area of FDI, which is important for preparing the local economy to meet the challenges of FDI, because the regulatory framework determines all activities relating to FDI and its role in the economy. These three components are not separate programmes but are an integral part of the aim, design and implementation of each project.

71. Regarding technical cooperation, a Transitional Economies and Free Zones Section was set up in May 1992. Further, the Director of the Transnational Corporations and Management Division is the Chairperson of the Inter-Agency Task Force on New Independent States. Other major activities of the Transnational Corporations and Management Division, to date, relate to the conduct of various meetings with the aim of facilitating joint ventures and FDI; the preparation of various documents and materials; and the provision of advisory services on foreign investment legislation and institutional frameworks and accounting in a market economy, including the establishment of the Task Force on Improvements in Accounting for Joint Ventures and advice provided towards the establishment and implementation of free economic zones. While, at the request of member countries, a comprehensive programme of activities has been identified, programme implementation remains subject to the availability of funding.

IV. CONCLUSIONS

72. The challenge of overall economic transformation and industrial restructuring in the CEE economies remains a complex task. Far-reaching changes are required, including changes in traditional attitudes; extensive policy reform; new legal and regulatory frameworks; sectoral and subsectoral restructuring programmes; comprehensive privatization; company rehabilitation and modernization; and technology and skill upgrading and retraining in various categories of technical, managerial and administrative staff. At this stage of the transition of the newly opened economies, FDI can play an important role as a catalyst in the opening-up process of the CEE economies, 25/ the enhancing of labour productivity and the transfer of management techniques and skills. In the short term, however, the positive contributions of FDI to transformation must be viewed together with continued requirements for commercial lending, official flows and other forms of non-equity investment.

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73. Foreign direct investment in the newly opened economies of Central and Eastern Europe remains in the early stages. Incomplete information, unreliability of data, and rapidly changing and evolving political, economic and social contexts make it difficult to assess with accuracy and in any degree of detail the short-term impacts of FDI on the sectoral restructuring of CEE economies. While FDI, in several country cases, remains predominantly service-sector oriented, it may be desirable to encourage FDI to contribute to a much needed restructuring and renewal of the manufacturing basis of CEE economies. Experience gained to date also points to the need for taking a gradual approach to the promotion of FDI, with careful time-phasing of well-specified and coherent policies and strategies for FDI promotion.

74. Most Governments have made considerable progress regarding the design and implementation of more enabling environments for FDI, including the identification of legal and regulatory frameworks. There remains a need, however, for enhanced transparency regarding policy and other provisions governing FDI, including simplification of institutional arrangements and processes. Again, experience gained points to the need for clear, coherent and transparent regulations regarding expatriation of profits; State guarantees against expropriation; agreements aimed at avoiding double taxation; tax and other incentives; and well-specified technology-transfer and environmental protection policies and strategies. Such comprehensive policy formulation and implementation capacities require continued strengthening. As FDI takes place within the overall macroeconomic and social context prevailing in host countries, macroeconomic and overall stability and predictability will be the main determinants regarding future FDI flows.

75. The newly opened economies of Central and Eastern Europe provide substantial opportunities for FDI development. These include large domestic markets, sustained strong consumer demand, availability of natural resources, access to a highly educated labour force, comparatively low production costs and access to regional markets such as the European Community.

76. There remains an urgent need, however, for strategic international technical support in assisting the transition economies in their efforts to strengthen FDI policy formulation and management capacity. Detailed country and interregional studies, international expert exchange, round-table meetings and training activities could all assist the CEE economies in promoting FDI and maximizing potential benefits from FDI to facilitate transition. Such assistance could also address: (i) regulatory and institutional development in the area of FDI, including studies assessing the potential for FDI, training workshops, investment promotion activities and the establishment and management of free economic zones; (ii) accounting and reporting developments, including improving the regulatory framework and education and establishing accounting and auditing professions; and (iii) entrepreneurial development, including the nurturing of local enterprises through business skill development and technical training.

77. In particular, technical assistance programmes can focus on the analysis, design and implementation of national transformation and privatization policies; the training of entrepreneurs, financiers and corporate managers; and specific investment promotion activities at the regional or country levels. Technical assistance could also be provided in the drafting of investment legislation; tax

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and other fiscal regulations affecting transnational corporations; and natural resource legislation in such areas as forestry, minerals, mining, petroleum and other programmes affecting the environment. Assistance could also be provided regarding the negotiation of joint-venture equity and management contracts, technology transfer contracts, the review and restructuring of ongoing contractual arrangements and enterprise development.

78. Considering the formidable challenge of establishing and maintaining an internationally competitive private sector, which will entail the establishment and management of advanced and sophisticated infrastructure and communication networks, finely attuned investment frameworks and economy-wide technologies, there is an urgent need for technical assistance in institution-building and human resource development. Such technical assistance could include the establishment and strengthening of investment boards and information systems on FDI, the identification of comprehensive and coherent policies and strategies facilitating FDI and the establishment and management of free economic zones.

Notes

1/ World Investment Directory, vol. II, Central and Eastern Europe (United Nations publication, Sales No. E.93.II.A.1).

2/ United Nations publication, forthcoming.

3/ For the purposes of this report, the following are included under CEE countries: Albania, Bulgaria, former Czechoslovakia, Hungary, Poland, Romania and the former USSR (comprising the Baltic republics, the Commonwealth of Independent States and Georgia).

4/ Economic Survey of Europe in 1991-1992 (United Nations publication, Sales No. E.92.II.E.1).

5/ World Economic Survey, 1992 (United Nations publication, Sales No. E.92.II.C.1).

6/ World Investment Report, 1992: Transnational Corporations as Engines of Growth (United Nations publication, Sales No. E.92.II.A.19).

7/ Country information was received from country questionnaires completed by national experts and comments made during the Ad Hoc Expert Group Meeting on the Role of Foreign Direct Investment in the Newly Opened Economies of Central and Eastern Europe, Sofia, Bulgaria, 5-7 January 1993. The meeting was organized by the Transnational Corporations and Management Division, Department of Economic and Social Development of the United Nations Secretariat in collaboration with the Government of Bulgaria.

8/ The Economist, (London), 19 December 1992, pp. 49-50.

9/ See World Bank, The Transformation of Economies in Central and Eastern Europe, Policy and Research Series, No. 17 (Washington, D.C., 1991).

10/ "The potential role of foreigners has been a matter of concern in all the CEE economies. Countries want the benefits of foreign expertise and foreign finance. But they are concerned that, in the absence of domestic sources of finance, foreigners will acquire a large part of industry at fire-sale prices. Accordingly at the same time as countries seek foreign expertise, in the form of technical assistance or management contracts, they make provisions to control the share of foreign ownership. These limits may appear redundant at present where there is no large flow of foreign finance into the formerly socialist economies. However, some limits are justified because large-scale foreign purchases at low prices could discredit the entire privatization process." From S. Fischer, "Privatization in East European transformation", in C. Clague and G. C. Rausser, eds., The Emergence of Market Economies in Eastern Europe (Oxford, Blackwell, 1992), p. 237.

11/ According to information provided by national experts.

12/ The total population of 387 million (1991) in the CEE countries is approximately 46.4 per cent of that of the developed market economies (United States of America, European Community, Japan and other). The former USSR makes up 75 per cent of the total population of the CEE countries. Within the former USSR, the Russian Federation makes up over 51 per cent of the total population of 290 million (1991).

13/ For example, "Gross financial disbursement to CEE countries are expected to total about $14.5 billion per year on average in 1991/92. Most will come from official sources, whose disbursements are expected to total almost $10 billion per year. (World Bank lending is projected at $2.5-3 billion annually, and IMF lending at about $4.5 billion in 1991 and $2 billion in 1992.)" From World Bank, The Transformation of Economies in Central and Eastern Europe, Policy and Research Series, No. 17 (Washington, D.C., 1991), p. 29. Further, it is estimated that "A relatively speedy transition (10-15 years) to West European income levels would require investment levels on the order of $200-400 billion per year ... Such investment levels are clearly impossible from the view of either resource availability or absorptive capacity. The unfolding experience of east Germany, though shaped by distinctive factors, appears to confirm the magnitude of the task ahead." From ibid., p. 66.

14/ The data on FDI and joint ventures contained in this section of the report were provided by national experts.

15/ World Bank, Foreign Direct Investment in the States of the former USSR, Studies of Economies in Transformation, Paper No. 5 (Washington, D.C., 1992), p. 8.

16/ See Statistical Survey of Recent Trends in Foreign Direct Investment in East European Countries ([EIECE]) TRADE R.575).

17/ Ibid., and information from national experts.

18/ See also P. J. J. Welfens, "Foreign investment in the East European transition", in Management International Review, vol. 32, No. 3 (Gabler Verlag, 1992), pp. 199-218.

19/ Among other important measures to attract FDI have been the recently concluded bilateral treaties for the avoidance of double taxation of income and capital of which most CEE countries are signatories. By 1991, Czechoslovakia had concluded 19, Hungary 10 and Bulgaria 8 treaties. Also relevant to the promotion of FDI is the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards. Bulgaria, Belarus, former Czechoslovakia, Hungary, Latvia, Poland, Romania, the Russian Federation and Ukraine are parties to the Convention, which binds countries to recognize arbitration awards made in foreign courts. Bulgaria, former Czechoslovakia, Hungary, Poland, Romania and the Russian Federation are also parties to the Paris Convention for the Protection of Industrial Property of 1883. In addition, on 22 June 1992, Slovenia deposited a declaration of continued application to its territory of the Paris Convention. By July 1992, the World Bank Convention on the Settlement of Investment Disputes between States and Nationals of Other States of 1965 had been ratified by Albania, Belarus, former Czechoslovakia, Estonia, Hungary, Kazakhstan, Lithuania and Romania, and the Russian Federation had applied for membership. In all these cases, the States of the region that have recently assumed responsibility for their own international affairs will have to notify the depositories of the above-mentioned treaties with regard to their position on those treaties in order to avoid doubts as to their commitments. Many countries are also parties to the Multilateral Investment Guarantee Agreement. See World Investment Directory, vol. II ...

20/ "If growth in CEE countries is to be accelerated, one needs to create a more productive institutional environment in which investment is made more profitable, and not simply provide increasing amounts of capital. The rather pessimistic picture presented at the beginning implicitly assumes that it will take a long time to create the institutions and capabilities that are necessary to assimilate large amounts of capital productively. It is that institutional gap, and not a capital gap, that needs to be solved if CEE is to have a chance of taking off." L. Summers, "The Next Decade in Central and Eastern Europe", in C. Clague and G. C. Rausser, eds., op. cit.

21/ See World Bank, World Development Report, 1991 (Oxford and New York, Oxford University Press, 1991), p. 154.

22/ Former economic policies in the CEE countries typically tended to undervalue natural resources and placed little value on environmental safeguards, which contributed to serious environmental degradation. This was particularly the case in regard to the pricing of natural resources in enterprise balance sheets in the former USSR.

23/ See Foreign Direct Investment Flows to Developing Countries: Recent Trends, Major Determinants and Policy Implications (UNIDO/PPD.167).

24/ See also United Nations technical publications in these subject areas.

25/ In this context, the General Assembly, in resolution 47/187 recognized "that the full integration of the economies in transition into the world economy should have a positive impact on world trade, economic growth and development, including that of the developing countries". It further recognized "the need for the international community to support the successful process of bringing about economic reforms and restructuring in the economies in transition with due regard to the developing countries among them, without adversely affecting development assistance to other developing countries".

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TRANSNATIONAL CORPORATIONS IN SERVICES, INCLUDING BANKING

Issues related to the liberalization of foreign direct investment in services

Report of the Secretary-General

SUMMARY

Services have maintained their role as the largest and fastest growing sector in both the flows and stocks of foreign direct investment, mainly as a result of investment among developed countries. Although foreign direct investment in services in the largest host developing countries has also grown the fastest, manufacturing remains the largest foreign-direct-investment sector in those countries. Foreign direct investment in services is likely to continue to grow rapidly and extend into such capital-intensive service industries as telecommunications and air transport in both developed and developing countries.

Foreign-direct-investment policies in services are being increasingly liberalized as a policy means to increase the efficiency and competitiveness of local service industries. Typically, this involves a move from the use of prohibitive instruments towards more open and liberal entry policies. More generally, it is often possible to find less restrictive, non-prohibitive measures, such as joint-venture requirements, which meet strategic or other non-economic objectives while at the same time, permitting local service industries to take advantage of foreign direct investment. As the experience of many countries with the liberalization of financial services shows, the opening of key services may lead to productivity gains that can improve overall economic performance.

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* E/C.10/1993/1.

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INTRODUCTION

1. At its eighteenth session, the Commission on Transnational Corporations requested that a report on transnational corporations in services, including banking, be prepared for consideration at its nineteenth session. This report has been prepared in response to that request. It analyses recent trends in foreign direct investment in services, including banking and other financial services, and examines issues related to the liberalization of foreign direct investment in services.

2. Recent policy developments and pronouncements suggest that a large number of developing countries have become genuinely interested in the development of a more efficient services sector or, at a minimum, in the improvement of selected service industries, primarily infrastructure and producer services. To achieve these objectives, countries are pursuing such policies as greater reliance on market forces, privatization of State-owned service companies and liberalization of international service transactions, especially the liberalization of foreign-direct-investment policies. Policy makers from developing countries are calling for a more efficient services sector, while central bankers underline the need for efficient financial services. A number of countries are doing what, a decade ago, would have been unthinkable: they are permitting transnational corporations into their financial, air-transportation, telecommunication and utilities industries.

3. These developments are occurring independently of the ongoing multilateral negotiations on international transactions in services. 1/ Still, while some developing countries are experimenting with unilateral liberalization, others are doing so within the framework of regional arrangements. For yet others, however, calls for action do not go much beyond declarations, perhaps because they are not certain about how to go about improving efficiency or because they become entangled in the political conflicts created by the issue itself.

4. The concern for greater efficiency in services results from the growing awareness of the role of services in the development process. Factors that are behind this growing awareness include the increasing contribution of services to employment and output generation, their interlinkages with other activities, the experience of developed countries with services deregulation and the impact of computer and communications technologies on a number of service industries. In addition, several developing countries have become keenly aware of the importance of such services as tourism, labour services, harbour services or transit-trade services, because, *inter alia*, they are hard currency earners or, in the case of producer services, they are basic for any efficient and competitive economy. Indeed, contrary to conventional wisdom, which sees growth in services mostly as a consequence of overall economic growth, there is a growing body of evidence suggesting that the development of certain service activities may not be a result of growth, but rather one of its preconditions.

5. Although there is a strong case on efficiency grounds for adopting liberal policies - policies providing for free and equal access of all qualified providers or suppliers, including foreign providers of services, to a country's market - cases of market failure as well as development considerations may justify policy intervention to regulate all providers and in some cases restrict

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the provision of services by foreign firms. Many countries thus implement measures of one kind or another that limit foreign providers' access to and competition in their national markets for services.

6. The distinctive aspect of services as compared with goods is that the simultaneous presence of producer and consumer at the location of consumption and production is necessary for most services. Arm's length exchanges or pure cross-border trade of services between producers and consumers located in different countries is therefore very limited. Service producers of one country can generally sell services to consumers in another country only through the establishment of a production facility; the establishment of a commercial office performing tasks that fall short of production but without which the provision of the service would be impossible; the temporary movement of service-production personnel; or the temporary travel of foreign consumers to the producer's country. Among these various modes of delivering services to foreign markets, foreign direct investment is the most important one. Accordingly, any review of policies affecting international transactions in services must necessarily begin, not with trade policies, which have traditionally been the focus of commercial policy discussion in the context of international merchandise transactions, but rather with foreign-direct-investment policies and policies related to the movement of personnel and consumers between countries.

7. Chapter I provides an overview of recent trends in foreign direct investment in services, including financial services industries. Chapter II provides a discussion of the issues related to liberalization of foreign direct investment in services, based on the text prepared jointly by the Transnational Corporations and Management Division of the United Nations and the World Bank for a publication entitled Liberalizing International Transactions in Services: A Handbook; the Handbook is the first output of a joint project between these institutions and the United Nations Development Programme on the expansion of foreign direct investment and trade in services (EFDITS) (see box below).

Box 1. Joint Transnational Corporations and Management Division/World Bank/United Nations Development Programme technical assistance project on the expansion of foreign direct investment and trade in services

Awareness about the contribution of services to economic development among policy makers has grown enormously in recent years. The negotiation of a General Agreement on Trade in Services (GATS) within the context of the Uruguay Round is an important factor that has contributed to this new attention for services. If and when GATS is adopted, a comprehensive framework for the liberalization of investment and trade in services will be put into place. Independently of GATS, however, the recognition that the international competitiveness of domestic producers is increasingly linked to their access to a modern infrastructure of producer services is another factor that has brought services issues to the fore of the policy agenda.

Increasing the effectiveness of the contribution of services to economic development raises a number of conceptual and practical questions. If effectiveness is to be improved in part through promoting greater competition in services industries, which itself may improve efficiency of producers and a better allocation of resources throughout the economy, at what point does the need for greater competition and the need for regulation conflict with each other? Do the goals of efficient producers and an efficient allocation of resources conflict with development objectives? What can be the contribution of foreign service providers to efficiency and development objectives? What are the costs or benefits of liberalizing market access for foreign service providers, be it through foreign direct investment or through trade? Is the nature of the trade-offs between foreign direct investment and trade the same in services as it is in goods? If warranted, how should liberalization of market access for foreign service firms be structured and implemented? What do liberalization and efficiency mean in the context of various market situations in different service industries with varying degrees of tradability and in countries at different levels of development?

Few answers to these questions are readily available. Unlike the case of goods, which economists have debated for years and for which a 40-year track record of experience with trade liberalization exists within the framework of the General Agreement on Tariffs and Trade (GATT), there is little accumulated experience of a research or practical nature at hand to guide action.

Within this context the Transnational Corporations and Management Division of the United Nations Department of the Economic and Social Development and the International Trade Division of the World Bank, with support from the United Nations Development Programme (UNDP), have embarked on a technical assistance programme for developing countries designed to address some of the above-mentioned issues. In its pilot phase, the expansion of foreign direct investment and trade in services (EFDITS) project is being implemented in four countries that have requested assistance: Thailand, Tunisia, Uganda and Uruguay. It seeks to provide advice on policy formulation in the area of services liberalization and support for follow-up implementation. Implementation follows the preparation of a joint United Nations-World Bank publication Liberalizing International Transactions in Services: A Handbook and a project operating plan that are used as guides to the development of the programme at the country level.

I. RECENT TRENDS IN FOREIGN DIRECT INVESTMENT IN SERVICES

A. Overall trends

8. During the late 1980s and early 1990s, services maintained and in some cases even reinforced their role as the largest sector in both the flows and stocks of foreign direct investment. By the early 1990s, their share in world stock was close to 50 per cent, and they accounted for some 55 to 60 per cent of annual flows. 2/ Although foreign direct investment in services has increased in absolute terms in both developed and developing countries, it has done so much faster in the former than in the latter. For example, by 1990-1991 the stock of foreign direct investment in the services sector was the largest sectoral stock in both the outward and inward investment of 8 out of 11 developed countries (or in the case of 16 out of 22 observations concerning both outward and inward stock); the same was the case in only 3 out of the 16 largest host developing countries. 3/ The flow figures reflect exactly the same picture.

9. It is not clear whether if the relatively lower level of foreign direct investment in services in developing countries is due to restrictive policies towards transnational service corporations or to the lack of locational advantages. To the extent that the former is the case, the countries involved may be depriving themselves of an important growth factor, to say nothing of foreign-direct-investment inflows, the majority of which, world wide, go to service industries.

10. Table 1 shows that, for the 10 largest home countries, the outward stock of foreign direct investment in services amounted to $726 billion in 1990, or 50 per cent of their total foreign-direct-investment stock. Their average annual services outflows were $97 billion during 1988-1991, or 55 per cent of their total annual outflows. The United States of America, traditionally the largest outward investor in services, with a stock of $223 billion in 1991, has been overtaken by Japan, which has emerged as the largest new investor in services, increasing its stock by $189 billion, or four and a half times, between 1985 and 1991, to achieve a total stock of $232 billion.

11. Developed countries are also the largest host countries for services foreign direct investment. The stock of investment in services in the 10 largest developed host countries was $500 billion in 1990, accounting for 48 per cent of their total stock (see table 1 below). In the 16 largest host developing countries, the value of the stock in services was $62 billion in 1990, or 30 per cent of their total inward foreign direct investment. As mentioned earlier, in most developing countries the manufacturing or primary sector, rather than the services sector, has been the largest sector for inward investment.

12. Finance, insurance and trading have attracted the largest share of foreign direct investment, dominating the outward stock of investment in services in 13 out of 16 developed countries and the inward stock in 17 out of 22 developed countries. 4/ In the developing countries the picture is more varied. For example, among 15 Asia and Pacific countries, finance and insurance combined is the largest foreign-direct-investment recipient in 4 countries, while trading services is the largest recipient in 3 countries. 5/

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Table 1. Sectoral distribution of foreign-direct-investment stock for the largest developed home countries and the largest developed and developing host countries, 1980-1990

	1980	1985	1990	1980-1985	1985-1990	1980-1990
Group of countries and sector	(Billions of dollars)			Average annual growth rate (percentage)		
Outward stock						
Developed countries a/						
Primary	88	115	160	5.5	6.8	6.1
Secondary	210	251	574	3.6	18.0	10.5
Tertiary	179	268	726	8.4	22.1	15.0
Total	477	634	1 460	5.7	18.2	11.8
Inward stock						
Developed countries b/						
Primary	18	39	94	16.6	19.0	17.8
Secondary	148	195	439	5.6	17.6	11.4
Tertiary	102	188	499	13.1	21.1	17.3
Total	268	422	1 032	9.5	19.6	14.5
Developing economies c/						
Primary	17	31	46	13.6	8.6	10.8
Secondary	41	64	102	9.4	9.8	9.7
Tertiary	17	34	62	14.4	12.5	13.5
Total	75	129	210	11.6	10.1	10.9

Source: United Nations, Department of Economic and Social Development, Transnational Corporations and Management Division, database on foreign direct investment.

a/ Australia, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom of Great Britain and Northern Ireland and the United States of America.

b/ Australia, Canada, France, Germany, Italy, Japan, Netherlands, Spain, United Kingdom of Great Britain and Northern Ireland and the United States of America.

c/ Argentina, Brazil, Chile, China, Colombia, Hong Kong, Indonesia, Republic of Korea, Malaysia, Mexico, Nigeria, Philippines, Singapore, Taiwan Province of China, Thailand and Venezuela.

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13. The historical country and industry pattern of foreign direct investment in services has been largely determined (and therefore distorted) by restrictive policies regarding such investment in many developed and developing countries, in contrast to less restrictive policies regarding foreign direct investment in manufacturing. History therefore reflects neither the relative propensities of individual service industries to transnationalize nor the locational advantages of countries regarding services foreign direct investment. This is rapidly changing, however; countries are opening up their service industries to various forms of foreign direct investment and services are becoming, for the first time, a routine subject of negotiations and liberalization agreements, treated in the same way as goods have been treated for many decades.

14. The internationalization of service industries through foreign direct investment is still in its early phases. It is therefore quite likely that the momentum of the growth in services foreign direct investment will be maintained or even increased during the 1990s. 6/ For one thing, demand for modern producer services, supplied mostly by transnational corporations, is growing rapidly in all countries, including developing countries. In addition, the countries of Central and Eastern Europe, in the transition towards a market economy, will need to make increasing use of such services as banking, insurance and other financial services, telecommunications, accounting and legal services. Countries also realize that the provision of many of those services will not be possible without the participation of transnational corporations. Moreover, the process of liberalization of foreign direct investment in services is a relatively recent phenomenon and is spreading to more countries as well as to more industries, including capital-intensive infrastructure services, such as telecommunications, transportation and public utilities, in which neither local nor foreign private ownership was previously allowed by most developed and developing countries, on the grounds of strategic considerations. Therefore, opening up to foreign direct investment in these industries, in most cases in the form of joint ventures, has been closely related to privatization programmes undertaken by many developed and developing countries. International transactions in services, including foreign direct investment, have also been liberalized within regional integration schemes in Europe (within the Single Market programme) and North America (United States-Canada agreement and the proposed North American Free Trade Agreement (NAFTA)).

15. Furthermore, transnational service corporations as a group are much less transnationalized than industrial firms, implying that there is considerable potential for rapid growth in services foreign direct investment in the future, especially in capital-intensive, technology-intensive and marketing-intensive industries, such as telecommunications and air transportation. It is quite possible that foreign direct investment in these two industries is already accelerating as a result of recent policy changes and that the available data (see table 1 above) do not yet reflect this acceleration. For instance, in 1991-1992 numerous agreements were concluded between airlines of different countries and many are still under negotiation, suggesting that a massive reorganization of the world airline industry through foreign direct investment is taking place. Similarly, the telecommunication industry has just been opened to large-scale foreign direct investment and is undergoing restructuring on a global scale. In addition, in service industries that are already transnationalized to a certain extent, such as banking and insurance, there is considerable potential for growth of foreign direct investment, as its

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liberalization is extended through regional integration schemes or as new home countries emerge as large investors (see sect. I.B below on financial services).

16. While there is little doubt that these and other factors will lead to an increasing transnationalization of service industries in the near term, technological developments may, in the longer run, alter the ways in which services are delivered to foreign markets. The limited tradability of many services has been a key factor favouring the rapid growth of foreign direct investment rather than trade. The advent of transborder data flows through the convergence of computer and telecommunications technologies changes this situation fundamentally, because transborder data flows permit instantaneous, long-distance, interactive transactions via transnational computer-communication systems. 7/ By collapsing time and space, transborder data flows make it possible for certain services to be produced in one place and consumed in another. The result is an increased transportability and, therefore tradability of certain services, especially information-intensive services, which may reduce the need for foreign direct investment to deliver those services to foreign markets. Alternatively, transnational service firms may be prompted to split their production processes into parts and, like their manufacturing counterparts, to allocate certain labour-intensive operations to foreign affiliates in order to take advantage of lower wages and other costs; that would result in both increased foreign direct investment and intra-firm trade in services. In conclusion, although the precise nature of the new technological opportunities and their full implications is still far from clear, there is little doubt that they will act in favour of a continued expansion of foreign direct investment and trade in services.

B. Financial services

17. As noted previously, the financial services industry is attracting one of the largest shares of outward as well as inward foreign direct investment in services of developed countries: the investment stock in financial services in developed host countries has increased at an average annual rate of 21 per cent during 1980-1990 (see table 2), compared to an average annual rate of 14.5 per cent for the stock of foreign direct investment in services as a whole (see table 1). The United States of America and Japan dominated outward investment stocks over the same period, while the United States and United Kingdom were the largest host countries for inward investment in financial services (see table 3).

18. In the developing countries, which are overwhelmingly host rather than home countries, the picture is mixed: the rate of growth of inward foreign direct investment in financial services in the major host countries during 1985-1990 rose slightly as compared with that in 1980-1985 (see table 2), but was lower than that of services taken as a whole in both sub-periods. Consequently, the share of financial services in total foreign direct investment in services declined during 1980-1990 (see table 2). In two major host countries, Brazil and Chile, however, foreign-direct-investment stock in financial services has grown more rapidly than the overall stock in services. 8/

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Table 2. Foreign direct investment in financial services including banking, stock, 1980-1990

(Billions of dollars and percentage)

	1980	1985	1990	1980-1985	1985-1990	1980-1990
Outward stock						
Developed countries _a_/						
Value	63.0	116.2	356.0	-	-	-
Share in total services stock	35.3	43.4	49.0	-	-	-
Average annual rate of growth	-	-	-	13.0	25.1	18.9
Inward stock						
Developed countries _b_/						
Value	28.4	60.7	187.1	-	-	-
Share in total services stock	27.9	32.3	37.6	-	-	-
Average annual rate of growth	-	-	-	16.4	25.3	20.8
Developing countries _c_/						
Value	3.3	4.6	6.8	-	-	-
Share in total services stock	32.6	25.0	22.5	-	-	-
Average annual rate of growth	-	-	-	6.9	8.1	7.5

Source: United Nations, Department of Economic and Social Development, Transnational Corporations and Management Division, foreign-direct-investment database.

_a_/ Australia, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom of Great Britain and Northern Ireland and the United States of America.

_b_/ Australia, Canada, France, Germany, Italy, Japan, Netherlands, Spain, United Kingdom of Great Britain and Northern Ireland and the United States of America.

_c_/ Argentina, Brazil, Chile, China, Colombia, Republic of Korea, Malaysia, Philippines, Thailand and Venezuela.

Table 3. Foreign direct investment in finance and insurance in the largest home and host countries, 1980-1990

(Billions of dollars)

Country	Outward stock			Inward stock		
Developed countries	1980	1985	1990	1980	1985	1990
United States	34.5	57.4	130.3	12.0	27.4	63.1
Australia a/	2.1	2.2	12.2	2.3	5.7	27.9
United Kingdom	0.2	8.3	22.4	0.7	5.2	27.4
Italy	1.4	6.6	25.1	0.9	4.2	23.7
Canada	3.1	9.2	19.1	6.5	10.2	21.4
France	2.5	5.7	19.5	1.7	2.2	16.5
Spain	..	..	..	..	1.1	11.4
Germany	4.6	8.8	21.8	2.9	3.6	9.2
Netherlands	1.6	5.7	16.1	1.3	2.1	6.6
Japan	2.4	10.8	65.3	..	..	0.7
Developing countries						
Brazil	..	..	..	0.7	1.1	2.3
Chile	..	..	..	0.1	0.5	1.2
Malaysia	..	..	..	1.4	1.6	1.4
Argentina	..	..	..	0.5	0.8	0.8
Thailand	..	..	..	0.1	0.1	0.4
Colombia	..	..	..	0.1	0.2	0.2
Philippines	..	..	..	0.2	0.3	0.2
Republic of Korea	..	..	..	0.1	0.2	0.3
China	..	..	..	..	0.1	0.1
Venezuela	..	..	..	0.2	0.1	0.1

Source: United Nations, Department of Economic and Social Development, Transnational Corporations and Management Division, foreign-direct-investment database.

a/ Including finance, property and business services.

19. Evolving strategies of transnational banks and other financial enterprises, as well as changing host country demand conditions and policies with respect to financial services, lie behind the acceleration of foreign direct investment in the industry in recent years. As regards transnational corporations strategies, most internationally operating financial institutions, including banks, insurance companies, securities houses and other financial services firms, have continued or resumed their efforts, which date from the 1960s and 1970s, to expand their international operations through foreign direct investment and cross-border transactions. However, although they still continue to serve the foreign affiliates of their home country corporate clients, their motivations now include actively making inroads into the domestic markets proper of their host countries. 9/ Two major trends have emerged in this respect. The first is the striking increase in international securities-related services provided through the establishment of affiliates in the main foreign securities markets as well as in a number of smaller countries with emerging capital markets; recent United States data showing the growth of finance other than banking relative to other categories seem to illustrate this trend (see table 4). The second is the attempt by banks and other financial institutions to expand their operations in the markets of their host countries via cross-border mergers and acquisitions, a strategy being applied in particular in the European Community, in response to the emerging unified market for financial services. 10/

Table 4. Composition of United States of America outward foreign-direct-investment stock in financial services, by category, 1987-1991

(Billions of dollars)

Category	1987	1988	1989	1990	1991
Banking	18.0	19.1	19.1	19.8	18.8
Insurance	11.6	13.2	14.2	16.1	16.3
Finance (except banking)	5.0	10.8	23.5	29.4	28.6
Holding companies	34.5	37.5	57.1	65.0	70.1
Total, above	69.1	80.6	113.9	130.3	133.8

Source: United States Department of Commerce, *Survey of Current Business*, August 1989 and August 1992.

20. Recent liberalization efforts by developed and developing countries have provided an environment conducive to the expansion of foreign direct investment in financial services. In developed countries, a major factor has been the amendment of the Organisation for Economic Cooperation and Development (OECD) Capital Movements Code in 1986 to include new provisions that strengthen liberalization obligations regarding the creation of transnational bank branches and agencies or other forms of establishment in the banking and financial services industry. The amendment extended to these forms of

foreign-direct-investment obligations already in force with regard to subsidiaries, regarding freedom of establishment, non-discrimination with respect to activities and national treatment. 11/

21. In developing regions, several countries in Latin America (including Argentina, Brazil, Mexico and Colombia) have liberalized to varying degrees rules relating to foreign investment in banking and other financial services. Asian countries such as India, Indonesia, the Lao People's Democratic Republic, Malaysia, Pakistan and the Republic of Korea have also revised their regulations to ease entry and/or ownership by transnational corporations of affiliates in banking and/or securities-related services in their economies. 12/ Several African countries which are looking for ways to attract foreign direct investment may also need to pay special attention to the improvement of the efficiency of their financial services through financial reform, including policies allowing greater participation of foreign financial firms. Growing demand for efficient and sophisticated financial services and privatization due to, inter alia, capital constraints faced by Governments, have strengthened the movement on the part of developing countries, towards liberalization in this industry, while the profitability of transnational bank operations in those economies that were already open to foreign financial firms, such as Hong Kong and Singapore, has increased due to rapid growth of domestic demand. 13/

II. ISSUES RELATED TO THE LIBERALIZATION OF POLICIES CONCERNING FOREIGN DIRECT INVESTMENT IN SERVICES

A. Introduction

22. The types of foreign direct investment through which services can be delivered abroad range from wholly owned affiliates of transnational corporations to joint ventures and non-equity arrangements. The last of these include such arrangements as professional associations (partnerships), franchises and management contracts, which are widely used in some service industries. Each of these forms satisfies the defining characteristic of foreign direct investment, namely that a firm in one country controls assets in another country.

23. Foreign direct investment and transactions associated with such investment can be promoted, contained or altogether prohibited by a variety of measures, ranging from direct regulations concerning the entry, establishment and activities of foreign companies (foreign-direct-investment policy proper) to broader rules on capital movement, foreign exchange or taxation. These measures can be grouped into three broad categories of instruments:

(a) Instruments relating to market access. These primarily regulate the entry and establishment of foreign companies in a host country. They range from bans on entry, that is, the total prohibition of foreign companies or the prohibition of certain types of operations or forms of investment, to complete freedom of entry and establishment. Limits on the level of foreign equity invested in domestic companies, for example, 49 per cent or less, also belong to this category, as do limits on the number of foreign firms in a market or industry or limitations on the geographical scope of their activities;

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(b) Instruments relating to standards of treatment. These include a spectrum of instruments determining the extent to which foreign firms receive treatment that differs from that accorded to domestic firms. These instruments may affect such areas as taxation, foreign exchange, borrowing, access to local markets and inputs, and exports and imports, and may be important enough to have a significant influence on the decision of foreign investors to invest or divest. For example, rules relating to external financial transfers or taxation are considered by most transnational corporations to be a crucial determinant of foreign direct investment;

(c) Other measures. These are measures which do not discriminate in theory between foreign and domestic firms but have that effect in practice. Important among them are instruments relating to the safety of assets and the right of exit of foreign companies, including protection measures and guarantees and rules governing expropriation, compensation and dispute settlement. Exit regulations may bear quite heavily on the decision by foreign investors to invest in a country. Instruments resulting from various areas of the general regulatory framework of a country can indirectly influence foreign direct investment and the activities of transnational corporations; they include such measures as the regulation of monopolies, competition policy, prudential regulations and consumer protection.

24. The present report focuses on issues related to the first category of measures and policies because total or partial prohibitions of foreign direct investment are still quite common in the service industries of developing and developed countries. While reviewing their policies, countries face issues related to the transition from a total prohibition of foreign companies, through the prohibition of certain types of investment and preference given to transnational corporations, to a wider opening of their service industries to foreign direct investment.

B. Liberalization of prohibitive policies

1. Instruments of total and partial prohibition

Total prohibition of foreign direct investment

25. Total prohibition is a measure that excludes foreign firms or individuals from any participation in the domestic economy or some industries in the economy. It is the foreign-direct-investment policy equivalent of an embargo or zero quota on cross-border imports of a product. Use of this instrument can be intentional and transparent as, for instance, when a foreign-direct-investment law or a constitutional provision explicitly specifies areas from which foreigners are excluded. Or it can be hidden, as in the case of countries where no legal instrument or policy proclamation excluding foreign enterprises exists, and approval or denial of entry is a matter of discretionary administrative decisions.

26. Sometimes, a prohibitive or exclusive effect can be achieved in the absence of any formal government restriction or screening practice. For example, the presence of public or private monopolies in an industry excludes the possibility of entry by a foreign company. There may also be impediments of an informal or

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structural nature that stem primarily from the business organization and culture of the country concerned. Japan and (to a lesser extent) Germany are examples of countries where inward foreign direct investment has been relatively weak despite a liberal investment regime.

Partial prohibition or limitations on certain types of investment

27. Prohibition does not have to be total but may be partial, through restrictions or limitations on some kinds of investment and preferences for others. Such limitations and preferences may apply as follows:

(a) Acquisition versus greenfield investment. Certain countries take a relatively liberal attitude towards the entry of foreign firms which establish new production facilities and are relatively restrictive towards the foreign acquisition of existing domestic enterprises. Restrictions may be enforced openly or indirectly; for example, merger-control provisions may be used to block acquisitions by foreign companies, even though they do not formally distinguish between domestic and foreign firms;

(b) Branches versus subsidiaries. Certain countries are reluctant to admit branch operations by foreign producers, while taking a more liberal attitude towards the establishment of subsidiaries. The reason is that the latter are separate legal entities incorporated under the laws of the host countries and therefore considered as local "corporate citizens";

(c) Equity versus non-equity forms of foreign direct investment. Countries that exclude equity participation may permit non-equity participation, such as licensing, franchising, management contracts and collaborative agreements. In many cases, the reason to prefer one form of participation over another is not clear and may vary according to industry or other circumstances. In the hotel industry, for example, the host country's preference for equity or non-equity forms (management contracts, franchising or technical assistance agreements) may depend on whether or not finance capital is available locally. 14/ Sometimes, instead of prohibiting foreign companies altogether from investing in an industry, countries may chose to prohibit forms of non-equity investment prevalent in the industry, such as franchising in the fast food and retail trade or management contracts in the hotel industry;

(d) Majority or wholly owned affiliates versus joint ventures. Some countries consider joint ventures as the preferable or even the only admissible form of foreign direct investment and require that a certain amount of equity (sometimes the controlling interest) be reserved for local investors. In this case, the prohibition of foreign enterprises is replaced by a limitation on the controlling share in equity ownership. As joint ventures represent forms of participation of transnational corporations that are of particular interest to developing countries and for certain service industries in both developed and developing countries, they are discussed separately in section II.C below.

Restrictions on the geographic location of foreign service affiliates

28. The entry of foreign firms may be restricted in terms of the geographical area in which firms are allowed to operate. This restriction is used frequently in banking, with many countries limiting the activities of foreign banks to the

country's largest business centre(s); but it may also be used across the board, as in China, where certain foreign firms are restricted to special economic zones.

Restrictions on the number of foreign firms

29. The entry of foreign firms may be limited to a fixed number of participants. Such quotas may be de jure or de facto as when a country refuses to issue new entry licenses to foreign firms. Open or hidden quotas are frequently used in banking, transportation, some professional services and other service industries.

2. Relevance to services

30. Outright prohibition of foreign companies was quite common two or three decades ago, especially in developing countries in the aftermath of decolonization and in socialist countries where a reliance on foreign capital was ruled out on ideological grounds. Today it is difficult to find any country that does not welcome foreign direct investment, at least in some industries. At the beginning of the 1990s, total prohibition tends to focus on a selected and declining number of industries which are considered to be important to national defence, national sovereignty or cultural identity; services figure prominently among them. They usually include most kinds of transportation (air, maritime and rail), broadcasting and media, telecommunications, public utilities and a number of professional services. In developing countries, the total exclusion of foreign firms (or the exclusion of controlling interests by foreign enterprises) has remained quite common in insurance, banking, advertising, retail trade and even tourism.

31. Instruments regulating certain key aspects of operations of foreign affiliates can be used in some service industries with a view to achieving a prohibitive effect. This may be the case with regulations related to the nationality and/or residence of the members of the board of directors of a service enterprise, its management and its employees. If requirements regarding local personnel, especially management, are considered by foreign investors as limiting their managerial capabilities, such requirements may negatively influence an investment decision or result in a withdrawal. In professional services which are normally provided by individuals, such as physicians, or partnerships, such as accountancy firms, a host country nationality requirement may also act as an absolute barrier to the establishment of foreign services providers. In many countries, admission to a professional association is a precondition to the practice of the activity and admission is often linked to citizenship or, at a minimum, to residence in the host country.

3. Elements for policy review and assessment

32. Where a Government pursues an objective that requires keeping foreign enterprises out, the advantage of prohibition, as a policy instrument, is its ability to deliver the desired outcome. The costs of such a policy include the possible loss of growth and efficiency, higher prices and lower productivity - in other words, the costs of protection. This general statement requires

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qualification when applied to foreign direct investment in service industries, however:

(a) First, the economic cost of prohibition may be higher than it is in the case of goods in part because the intra-firm division of labour and intra-firm trade tend to be lower among transnational services corporations than they are among transnational manufacturing corporations. 15/ Foreign services affiliates are often miniature versions of their parent companies, rather than specialized elements in world-wide systems of production. The implication is that, for a given amount of foreign direct investment, investment in services tends to produce greater economic development benefits in terms of transfer of technology, skills, supply of unique services or productivity gains than the same amount of investment in manufacturing;

(b) Second, it is difficult to assess the costs and benefits of prohibiting foreign direct investment or other forms of participation by transnational corporations in the case of services, because the benefits quite frequently involve considerations other than strict economic efficiency, such as national sovereignty and cultural integrity. Such benefits are typically highly subjective and hard to measure in monetary terms. The costs, however, can be assessed in terms of lost efficiency, higher prices for users or lower economic growth.

33. Even though prohibitive or restrictive policies with respect to foreign direct investment and transnational corporations may be adopted in the pursuit of apparently sound objectives, these should periodically be re-examined for their usefulness. There are several reasons for such a re-examination. First, national objectives are not static and parameters defining their relevance may undergo substantial changes. For example, technological change may vastly increase the range of application of certain services and as a result move an industry from the margin to the centre of national interest, as has been the case for telecommunications in recent years. The availability, price and quality of telecommunications services affect so many other economic activities today that pressure on Governments to improve such services has increasingly overshadowed concerns about foreign presence. Second, with the advent of new decentralizing technologies (for example, home video and satellite transmissions), Governments may be losing their ability to keep whole industries or markets under their control, even if they were able to use quite efficient instruments of control in the past. Third, there is always the possibility that national defence or strategic importance arguments are being or have been used by established producers to protect widespread inefficiencies. It has been pointed out that national defence, like patriotism, may be the last refuge of those seeking selfish protection but willing to wrap the flag around their interests; this applies both to tariffs and to prohibitions against foreign direct investment in particular fields. 16/ It may also be that prohibition, although perhaps justified on national defence grounds, is quite liberally extended to industries or activities where it rather "smacks of protection, not national defense". 17/ And, last but not least, countries may gradually become less sensitive to a growing foreign presence in their economies because the cost of supporting too many inefficient national industries becomes too high and the positive experience of other countries with foreign enterprises becomes undeniable. Furthermore, many concerns related to the presence of transnational corporations often do not materialize. For example, in services such as

accounting, engineering or even banking, foreign companies, instead of crowding out local firms, often operate in market niches not competing directly with local firms.

34. If a country decides to continue with restrictions, the least it can do is to consider alternatives; there may be other, less costly and less prohibitive instruments for achieving the same objective. 18/ Total prohibition may be replaced by milder forms of limitations on foreign presence, such as minority joint ventures, which may be less costly in terms of technology transfer or access to capital. For example, joint ventures with a foreign partner in a telecommunications or public utility may be less costly than the absolute exclusion of foreign companies and exclusive reliance on domestic providers. Likewise, permitting limited activities of transnational services corporations operating in market niches and catering to the needs of transnational manufacturing corporations may be less costly than a total exclusion that could lead to more costly substitutes produced by indigenous firms.

35. Sometimes, economic considerations, such as those relating to the balance of payments, motivate severe restrictions in service industries, for example in the area of financial services. Foreign direct investment may be prohibited on the grounds that it is expensive, or it may be limited to export or import-saving industries to ensure that the transfer of profits and/or savings to foreign owners will not put undue burdens on the balance of payments. The policy assessment in this case is more straightforward, because the supposed expected benefit is economic in nature and should therefore be quantifiable. A narrow, one-industry approach to balance-of-payments problems is not appropriate, however. Rather, economy-wide effects of any restrictions should be taken into account. For instance, in the area of insurance services, the exclusion of foreign insurers and the requirement that primary insurance be bought only from domestic firms may lead to increased dependence on foreign reinsurance and a resulting increased outflow of reinsurance premiums. However, this outflow may be more than offset by the prompt payment of claims. 19/ If efficient producer services provided by transnational corporations enhance the export capacity of a host country, the indirect gains in export earnings may be significant and should be taken into account in any policy assessment concerning the presence or exclusion of foreign service companies.

36. If countries wish to depart from the policy of total prohibition of foreign companies in their service industries based on non-economic objectives but are not yet ready to grant the right of establishment to all foreign service producers, the choice of foreign-direct-investment instruments and forms and their policy assessment will depend on the policy objectives and the concrete situation in a specific service industry. No form of foreign direct investment should be *a priori* discarded as automatically harmful, or another preferred as automatically guaranteeing greater benefits. For example, takeovers and acquisitions of domestic companies are normally viewed with suspicion, as possibly resulting in anticompetitive behaviour, running counter to the industrial policy objectives of host countries and exacerbating fears of foreign dominance. In certain situations, however, they can be beneficial. Foreign participation in existing domestic firms may often be the only device available to enhance the efficiency of those firms or to rescue ailing enterprises by injecting new capital and know-how. In many countries, foreign participation through acquisition, in the absence of sufficient domestic savings, is

indispensable to the success of privatization programmes in capital-intensive services such as telecommunications or transportation. Acquisitions can also be used in the context of debt-equity conversion schemes, which may improve the external debt and payments situations of host countries while recycling resources for productive uses.

37. If the objective of a new policy is to achieve greater efficiency of a service industry through the establishment of a competitive environment, then discarding prohibitive foreign-direct-investment instruments should be part of a broader policy reform which, depending on the service industry, may include a number of accompanying measures, such as the privatization of domestic companies; market opening not only for foreign but for all companies; the strengthening or introduction of prudential regulations or other consumer-protection regulations; and the strengthening of anti-monopoly regulations. Such reform would take into account differences between service industries.

4. Experience

38. An analysis of experience in the use of market-access instruments can be undertaken from two perspectives. One perspective looks at countries or industries in which market-access restrictions have been applied for a long time and that are just beginning to open up their economies; this type of analysis focuses on the consequences of keeping foreign companies out. A different perspective looks at countries that lifted bans on the presence of foreign companies some time ago and have experienced foreign direct investment in services for a number of years. Both types of country experience provide strong evidence suggesting that high levels of protection of domestic services, combined with public ownership and excessive economic regulation, have been detrimental to the efficiency of the industries concerned and have imposed widespread costs on their domestic economies. Both also suggest that opening up to foreign direct investment can bring benefits to the countries concerned. This can be illustrated by examples from the financial sector in both developing and developed countries.

39. In India, foreign direct investment in the financial sector has remained tightly controlled and subject, until recently, to a 40 per cent ceiling on foreign equity participation. The profitability of banks has suffered through a combination of nationalization and the obligation to provide low-interest loans to priority sectors. 20/ To meet such requirements, banks had to fix interests rates on deposits far below market rates and thus have failed to mobilize domestic savings to the maximum extent possible. Similarly, Brazil's commercial banking, which faces significant regulation, has had one of the lowest efficiency indexes in Latin America. 21/ Yet both India and Brazil have large markets and an educated workforce. A relaxation of restrictions could result in considerable efficiency gains and growth in the banking industry, not only through the expansion of the national markets but also through its overseas expansion. Indeed, such changes began to occur in Brazil after 1990 and in India in 1992.

40. Australia and Spain are prominent examples of successful banking liberalizations among developed countries. In Australia, the deregulation of

the banking system, which began in the early 1980s, was accompanied by the licensing of 16 foreign commercial banks. This led to substantial inflows of foreign direct investment, which transformed the financial market. The entry of foreign banks provided more intensive competition and downward pressure on rates and profit margins. Fears that this would result in foreign dominance of the market-place did not materialize; two years after the entry of the foreign banks, the local banks still accounted for 90 per cent of total assets. 22/ While foreign banks, taken as a whole, are larger in size and more advanced in technology and financial techniques, domestic banks have extensive retail deposit bases and well-established relations with corporate customers, two important advantages in competing with foreign banking affiliates. In Spain, the experience with the liberalization of financial services has been equally positive. The competition and innovation fostered by foreign banks in a market that used to be characterized by some of the highest margins in Europe has brought significant benefits to consumers and corporate users and should serve as a catalyst for Spanish banks to become more competitive internationally.

41. Positive experiences with the liberalization of banking services are by no means confined to developed countries. Case studies of transnational banks and financial markets in developing countries have shown useful synergies between foreign and domestic banks. 23/ For example, one beneficial effect from opening the banking sector to foreign direct investment is an increase in financial flows, in particular the growth in syndicated loans that is facilitated by the presence of foreign banks. In developing countries with large domestic markets open to foreign banks, the use of modern payment instruments such as credit cards and cheques has become more widespread and local banks have been stimulated to use modern computer technologies. Concerns that foreign banks might end up dominating the domestic market have typically proven unwarranted. Instead, a complementary role has developed between foreign and domestic banks: while the former tend to focus on international transactions, wholesale banking and trade facilitation, the latter have continued to dominate retail banking. This complementarity of roles, in other words, this specialization, is not due to regulatory constraints but is largely the result of differences in comparative advantages between foreign and domestic banks. 24/

42. To sum up, it is probably almost always possible to find a less restrictive measure for preserving the national interest while at the same time taking advantage of foreign direct investment. The opening of key service industries may bring about productivity gains that may significantly improve overall economic performance. Import substitution policies based on restrictions on trade and investment, on the other hand, may entail high economic costs and harm the expansion of the national economy.

43. Another lesson from the experience of many countries is that liberalization measures need to be carefully designed, taking into account the effects of previous regulatory constraints on the domestic services industry. For instance, if the balance sheets of domestic banks are burdened with a large proportion of bad loans granted in accordance with instructions from government authorities, these banks cannot be exposed to foreign competition without prior measures to help them redress their financial situation. Under conditions of liberalization, unprofitable loans granted for social purposes should be subsidized out of government funds and not out of low-interest rates on

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deposits. Where necessary, prudential regulations should be introduced or reinforced to increase confidence in the banking system. The privatization of government-owned banks could also help improve the efficiency of the national banking sector. In other words, the liberalization of services industries should be part of a broader design of financial sector reform.

C. Liberalization of ownership-restriction policies

1. Instruments and their relevance for services

44. Measures to restrict foreign ownership in the equity of enterprises, either across the board or in particular sectors or industries, constitute an important if specific group of foreign-direct-investment policy instruments. They prescribe a maximum limit for the share of equity that can be held by a foreign firm or individual, requiring, in effect, that foreign participation take the form of a joint venture involving host country nationals as shareholders. In contrast to the instruments discussed in section II.B. above, they do not limit the participation of (partly) foreign companies in an industry or market. In extreme cases, foreign companies may even dominate an industry, provided that local interests have a share of equity in the foreign affiliates involved. At another extreme, ownership restrictions may act as a deterrent to keep foreign companies out altogether.

45. There can be two distinct groups of reasons for imposing ownership restrictions. First, they can be used to ensure local or national control at the firm and/or industry level, with a view to achieving some of the non-economic objectives discussed in the preceding section. If ownership restrictions are used with this objective in mind, the permitted form of foreign direct investment is usually a minority joint venture. Second, they may aim at achieving economic objectives such as macroeconomic and monetary stability and consumer protection, on the grounds that it is easier to monitor and discipline nationally controlled enterprises, or to share benefits with local interests.

46. Across-the-board rules prescribing maximum foreign ownership of enterprises were contained in the regulations of some developing countries, as well as implicitly enforced in the screening procedures of some developed countries until the early 1980s. 25/ Although the prescription of ownership requirements for foreign direct investment generally has declined since the mid-1980s, a number of service industries have continued to be subject to ceilings on foreign ownership in developed and developing countries. Paradoxically, this can be largely explained by progress in the liberalization of services foreign direct investment, involving a movement from total prohibition to the opening up to foreign participation of various kinds as well as a movement from lower to higher permitted foreign equity levels. A number of Latin American countries, for example, have opened their telecommunications industries to transnational corporations, permitting minority foreign ownership in basic telecommunications and higher foreign ownership shares in value-added services; Singapore has increased the foreign equity shares permitted in banks from 20 per cent to 40 per cent; and Indonesia has announced plans for relaxing foreign ownership rules in banking. India has raised permitted foreign ownership of hotels from a minority share to over 51 per cent. Among developed countries, the United States has raised permitted foreign ownership shares in

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air transportation and the United Kingdom in telecommunications firms. Given the currently increasing frequency of foreign direct investment in these two industries, joint ventures may become the norm in these industries in both developed and developing countries.

2. Elements for policy review and assessment

47. If the policy objective is non-economic or is related to monopoly and requires that domestic control be retained, then the conclusions from section II.B above apply here as well: joint ventures are a better instrument than prohibitions, especially in industries in which monopoly is the norm but which are in need of modernization, such as telecommunications, public utilities and rail transportation. If an industry includes many firms, however, domestic management and control of each and every enterprise is not necessary for avoiding dependence on transnational corporations; if there are no restrictions on entry, locally owned companies are likely to coexist with foreign affiliates, reducing the danger of dependence.

48. As far as economic objectives or benefits are concerned, it should first be noted that most of them are linked not so much to the local equity itself as to the management and control that this equity is supposed to provide. While it is correct that, in most cases, majority equity participation ensures control, in many other cases, involving a number of service industries, control can be exercised with low-equity shares or even without any equity and can be derived from non-equity arrangements.

49. Assuming, however, that majority ownership is sufficient for the control of an enterprise, a case for across-the-board joint ventures in preference to fully foreign-owned subsidiaries can be made if economic benefits of national control outweigh the costs. The major expected advantage of joint ventures is their greater contribution to the development of local entrepreneurship and to the acquisition of technology and skills by host country nationals. The expectation is that joint ventures, as well as non-equity arrangements, allow for a larger role for host country nationals than do fully foreign-owned affiliates; this, in turn, is expected to strengthen domestic entrepreneurial and technological capabilities through management control, training or interaction with expatriates. But this may not always be the case. It is less likely that it will happen in countries at an early stage of development, with weak domestic educational and technical endowments. Nor is it a realistic expectation in more sophisticated industries, either because transnational corporations are unwilling to provide more sophisticated technologies under non-equity or low-equity arrangements, or because local abilities to put the package together are less adequate, even in more advanced developing countries, the more sophisticated the technologies. Finally, whether a joint venture approximates more nearly a fully or majority foreign-owned subsidiary or an arm's length arrangement for the transfer of technology depends on the specific conditions of both the industry and the joint venture and the capabilities and bargaining power of the joint venture partners.

50. The principal economic costs of ownership restrictions, especially if they take the form of permitting minority foreign equity participation only, are related to the fact that they act as deterrents to foreign direct investment by

some potential investors. Costs include not only the reduction in capital flows that is likely to occur, but also the lack of access to the other contributions that may be associated with foregone investments, including access to sophisticated technology, which is generally associated with higher equity stakes by transnational corporations; access to markets, which would be important in export-oriented industries; and greater operational efficiency and competitive effects due to economies of scale and scope often enjoyed by transnational corporations.

3. Experience

51. The literature on industrial joint ventures, which is plentiful, in contrast to the dearth of literature on joint services ventures, suggests that minority foreign-owned or non-equity joint ventures do not necessarily or automatically guarantee certain benefits in terms of the transfer of skills and technology to a host country in distinction from majority or wholly foreign-owned affiliates. However, under certain conditions, joint ventures that are predominantly or wholly locally owned confer greater learning and more effective transfer of technology than firms with significant ownership and control by transnational corporations. 26/ This applies, however, only if the host country has already reached a certain degree of development and has the necessary abilities for technology absorption. 27/ The nature of the industry is also relevant, with transnational corporations being more reluctant to provide sophisticated technologies under low-equity or non-equity arrangements.

52. These general conclusions can also be applied to joint ventures in service industries. Whether joint ventures are the most appropriate form for the acquisition of technology and skills in services is likely to depend on the stage of development, the industry in question, and the negotiating capabilities of the parties concerned. It is also relevant to note that training is likely to be the most important channel for the transfer of services technologies and transnational corporations have been observed to perform adequately in this area, as distinct from research and development, technology choice and innovation. 28/ Thus, fully or majority-controlled affiliates may contribute more to the transfer of technology in service industries than in manufacturing. Much depends, however, on the circumstances, including the availability of locally educated specialists.

53. As for ownership restrictions acting as a deterrent to foreign direct investment, the experience is not unequivocal. Certainly, countries applying across-the-board ownership restrictions, such as India and the former centrally planned economies, receive relatively less foreign direct investment or hardly receive such investment at all. But these countries either have cautious attitudes to foreign direct investment in general or an attitude based on unrealistic expectations and ownership restrictions are merely one expression of this attitude. On the other hand, if the foreign-direct-investment climate is generally favourable, as for example in Thailand, local ownership requirements in service industries, such as advertising, hotels and entertainment, do not seem to have a substantial effect on foreign direct investment in these industries.

54. In some service industries, the experience of developing countries with joint ventures dates from the 1960s and 1970s, when a number of countries attempted to regain national control over their economies, including key services; in other industries, such as telecommunications, transportation and public utilities, which have recently embarked on a number of joint ventures, it is too soon to draw meaningful conclusions. Past experience, even though seemingly obsolete, may still be instructive, as an example from Morocco shows. Morocco was one of many developing countries in the early 1970s that undertook the "indigenization" of the local economy, then largely dominated by foreign capital (foreign companies controlled two thirds of the banking and insurance institutions). The effort, based on a 1973 law, provided for a transformation of foreign-owned companies into joint ventures in which Moroccan capital should hold at least 50 per cent equity. Following this law, the number of foreign companies was substantially reduced; in banking and insurance, the formal requirements were soon met, mainly through the restructuring of ownership in existing foreign companies, only a few of which withdrew at that time. Although the Moroccanization campaign was quickly abandoned, the majority local ownership provisions were retained in the case of banks and insurance companies. However, despite these provisions, effective control has frequently remained with foreign partners, due to two factors. First, Moroccan administrators could delegate their power to foreign personnel holding managerial positions, an option widely used due to the lack of skilled local personnel able to deal with complex financial transactions. And second, it was necessary to avoid conflicts with foreign partners in order to ensure the transfer to local personnel of know-how and training in sophisticated financial techniques. 29/

D. Conclusions and policy recommendations

55. In assessing the usefulness of prohibitive instruments regarding foreign direct investment in service industries, policy makers should take into account a number of considerations, many of which are common to any policy review. They should clearly identify the objectives of their policies and examine their validity and cost to consumers, producers and the Government. Objectives should be clearly stated and regularly re-examined. Policy makers should examine the instruments currently being used to see if there are less restrictive and less costly instruments that could serve the same objectives. In this context, it is important that the interests and views of all parties concerned (producers, consumers etc.) are identified and adequately taken into account. While considering policy changes, policy makers should be fully aware of the adverse effects of existing investment prohibitions and should identify the benefits expected from foreign direct investment in services and the measures that could help ensure that such investment meets the expectations of the host country. They should, furthermore, review and implement measures that may encourage a complementarity between foreign and domestic investments in service industries.

56. If a country decides to reduce the number of industries or companies affected by total prohibitions on foreign direct investment but still wants to monitor the entry of foreign companies, it should carefully review and if necessary alter its monitoring or screening mechanisms to make sure that they are free from hidden obstacles that might continue to discourage foreign companies from investing. If a country decides to abolish prohibitive instruments, it should decide how far it intends to go with liberalization. If

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the objective is to improve the efficiency of the services sector, liberalization may need to be far-reaching and may need to be preceded or accompanied by domestic regulatory reforms and other measures aimed at enhancing the competitiveness of national services producers and protecting consumers.

57. In reviewing and considering the liberalization of ownership restrictions, policy makers should consider the effectiveness of joint ventures for attaining their objectives. Specifically, the existence of conditions conducive to encouraging the transfer of technology through joint ventures should be examined. If these conditions are absent, the cost of joint ventures in terms of deterrence of foreign direct investment and other associated benefits may not be justified.

58. It should also be noted that a distinction between voting and non-voting stocks may provide the benefits of control with a smaller cost in terms of investment forgone. In monopoly and oligopolistic industries in which joint ventures are preferred, the degree of ownership may be used as a negotiating tool; a higher ownership stake could be offered to a foreign firm offering more resources or other benefits.

Notes

1/ For a review of the emerging General Agreement on Trade in Services, see World Investment Report 1992: Transnational Corporations as Engines of Growth (United Nations publication, Sales No.E.92.II.A.19), pp. 66-69.

2/ See World Investment Report, 1991: The Triad in Foreign Direct Investment (United Nations publication, Sales No.E.91.II.A.12), pp. 15-22, for a discussion of the sectoral shift of foreign direct investment towards services.

3/ United Nations, Department of Economic and Social Development, Transnational Corporations and Management Division, foreign-direct-investment database.

4/ World Investment Directory, vol. III, Developed Countries (United Nations publication, forthcoming).

5/ World Investment Directory 1992, vol. I, Asia and the Pacific (United Nations publication, Sales No. E.92.II.A.11), p. 25.

6/ See World Investment Report, 1991 ..., pp. 21-22.

7/ Karl P. Sauvant, "The tradability of services", in World Bank and United Nations, The Uruguay Round: Services in the World Economy (Washington, D.C., 1990), pp. 114-122.

8/ Based on Transnational Corporations and Management Division, World Investment Directory, vol. IV, Latin America and the Caribbean (United Nations publication, forthcoming). During 1980-1990, foreign-direct-investment stocks in finance and insurance increased at average annual rates of 14 per cent in Brazil and 27 per cent in Chile, while foreign-direct-investment stocks in services as a whole increased at average annual rates of 10 per cent in Brazil and 26 per cent in Chile.

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9/ Organisation for Economic Cooperation and Development, Banks under Stress (Paris, 1992), pp. 23-24.

10/ Ibid.

11/ Organisation for Economic Cooperation and Development, Liberalisation of Capital Movements and Financial Services in the OECD Area (Paris, 1990), pp. 59-60.

12/ Business International Corporation, Investing, Licensing and Trading Conditions Abroad, various country reports for Asia and Latin America (New York, 1990-1992).

13/ Asian Wall Street Journal, 24 February 1992.

14/ Transnational Corporations in International Tourism (United Nations publication, Sales No. E.82.II.A.9), p. 30.

15/ See Foreign Direct Investment and Transnational Corporations in Services (United Nations publication, Sales No. E.89.II.A.1), p. 114.

16/ Charles P. Kindleberger, Multinational Excursions (Cambridge, Massachusetts, The Massachusetts Institute of Technology Press, 1984), p. 54.

17/ Ibid., p. 53.

18/ Ibid.

19/ See Organisation for Economic Cooperation and Development, Trade in Services and Developing Countries (Paris, 1989), p. 20.

20/ See Surjit S. Bhalla, "India", in World Bank and United Nations, The Uruguay Round ..., pp. 188-196.

21/ See C. A. Primo Braga, "Brazil", in World Bank and United Nations, The Uruguay Round ..., pp. 197-209.

22/ Organisation for Economic Cooperation and Development, Foreign Direct Investment: Policies and Trends in the OECD Area (Paris, 1992).

23/ See Organisation for Economic Cooperation and Development, Trade in Services ..., pp. 17-18.

24/ See D. A. Germidis and C. A. Michalet, International Banks and Financial Markets in Developing Countries (Paris, Organisation for Economic Cooperation and Development, 1984).

25/ Government Policies and Foreign Direct Investment, UNCTC Current Studies, Series A, No. 17 (United Nations publication, Sales No. E.91.II.A.90), p. 8.

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26/ See, for example, *Technology Acquisition under Alternative Arrangements with Transnational Corporations: Selected Industrial Case Studies in Thailand*, UNCTC Current Studies, Series A., No. 6 (United Nations publication, Sales No. E.87.II.A.14), pp. 47-48; and Frances Stewart, "Technology transfer for development", in Robert E. Evenson and Gustav Ranis, eds., *Science and Technology: Lessons for Development Policy* (Boulder and San Francisco, Western Press, 1990), p. 316.

27/ Frances Stewart, *loc cit*.

28/ Ibid.

29/ United Nations, "Transnational service corporations in Morocco, Tunisia and Algeria", 7 June 1991, unpublished mimeograph.
